

07048329

P.E.  
12/31/06

AR/S

RECD S.M.A.

MAR 29 2007

2007

1-07850

# Southwest Gas Corporation

PROCESSED

APR 05 2007

B

THOMSON  
FINANCIAL

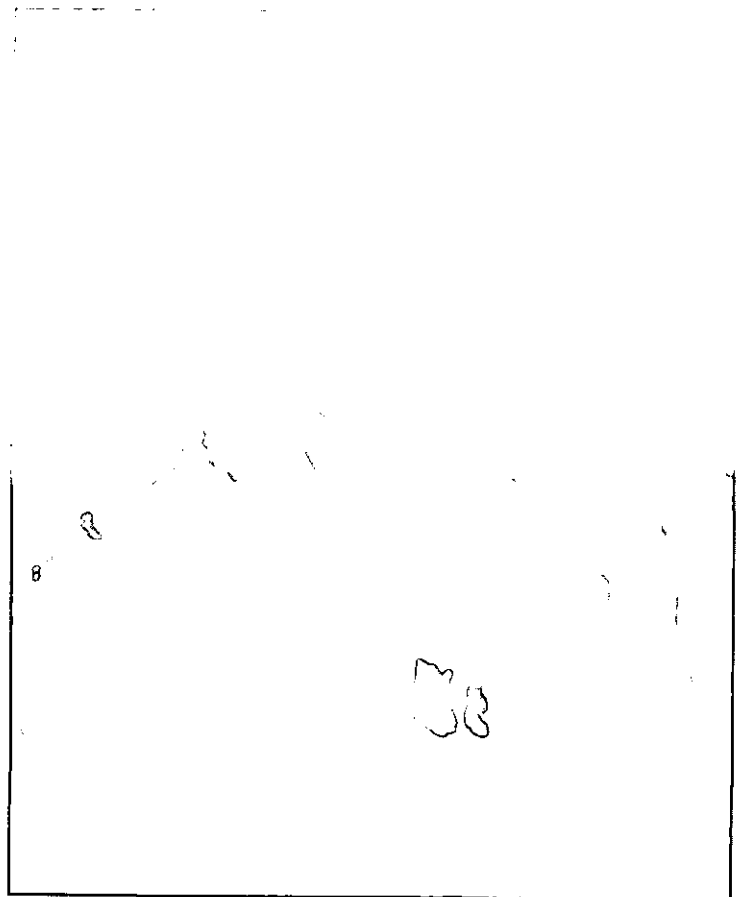
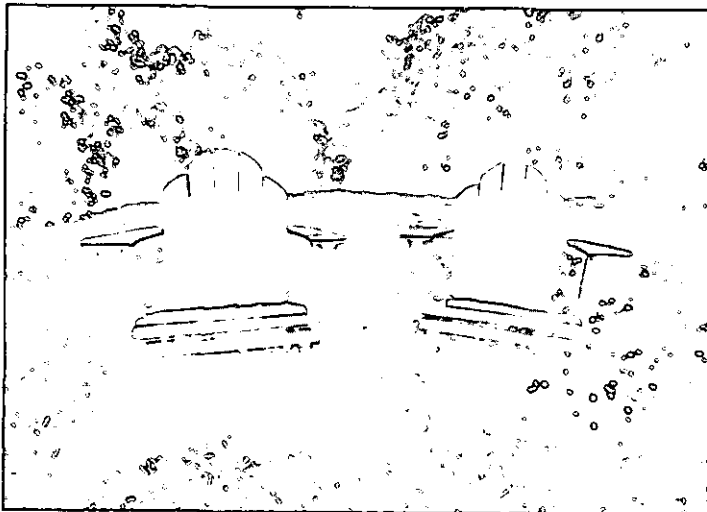
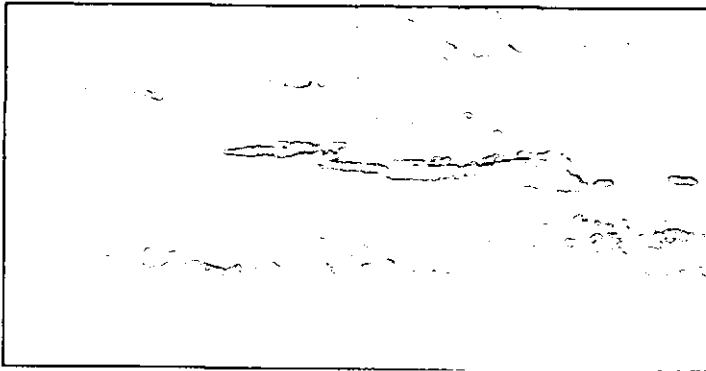
ANNUAL REPORT 2006

For centuries,  
people of all ages  
have congregated  
around the fire.

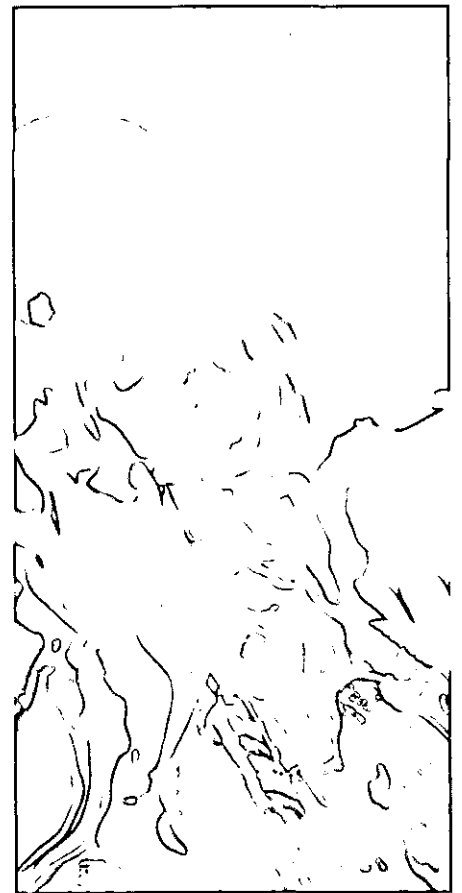
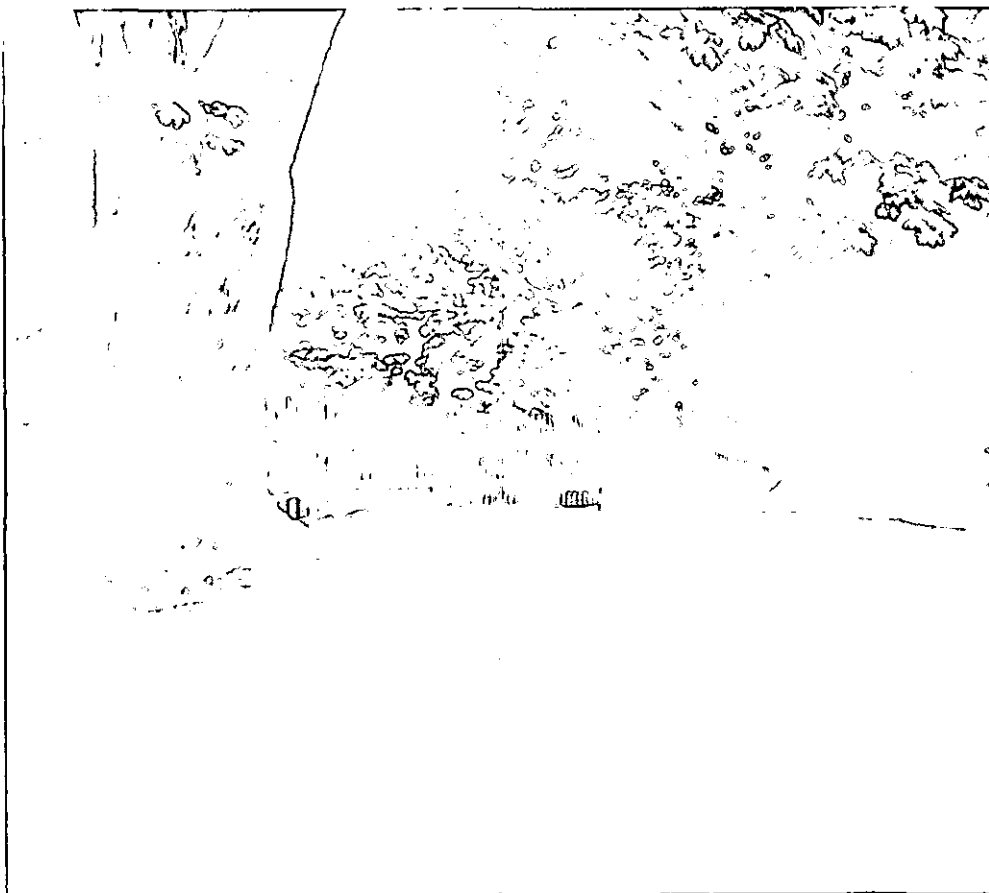
It's a place where  
life's toughest  
challenges can  
be talked through,  
and the greatest  
moments recounted.

The dance and  
heat of the fire,  
shared by a  
circle of friends,  
create the perfect  
environment for  
conversation.

02



Natural gas  
fire pits bring the  
generations-old  
storytelling into  
the confines of your  
own backyard.



The tales that  
unfold in the glow  
of the flames  
are typically  
larger than life.



*Pecos Bill is a legendary cowboy hero of the American Southwest. He personified the frontier virtues of strength, courage, ingenuity, audacity, endurance and humor. Through a series of superhuman feats, he was said to have played a key role in taming the Western frontier.*

The youngest of 18 children of a Texas pioneer, Bill used a bowie knife as a teething ring and played with bears and other wild animals as an infant. After falling out of his parents' wagon near the Pecos River in Texas, he became lost and was raised by coyotes. In fact, he considered himself to be a coyote until a cowboy convinced him of his true identity.

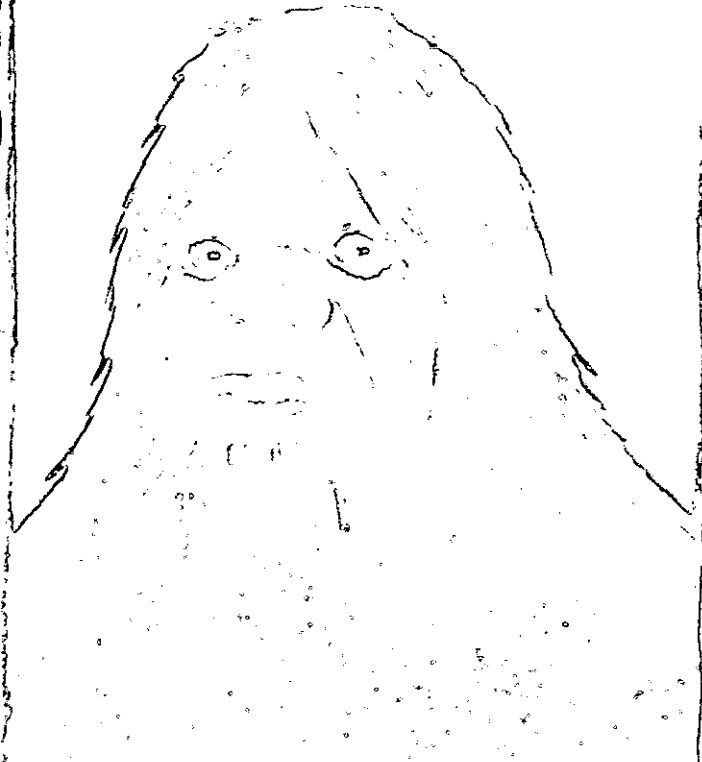
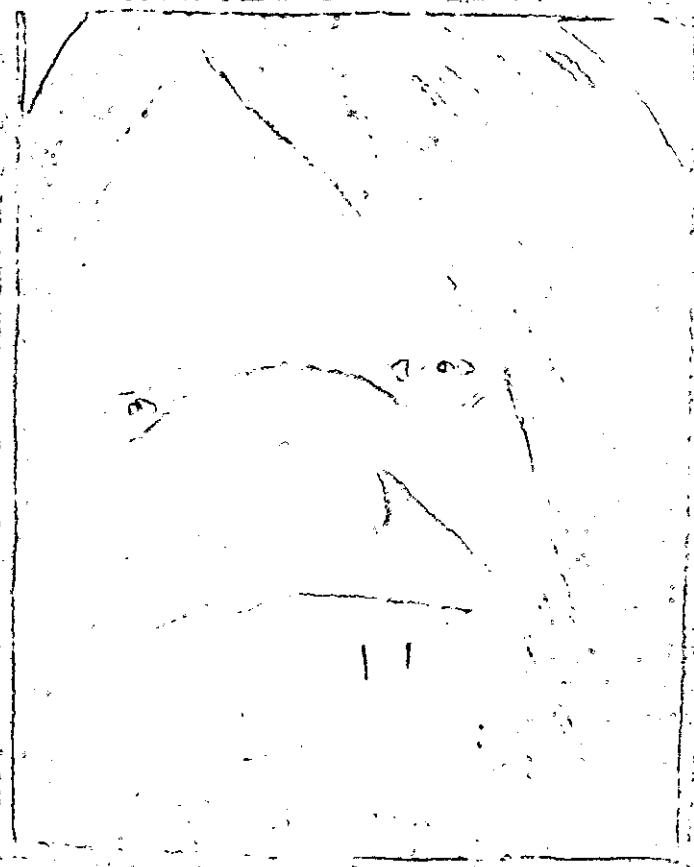
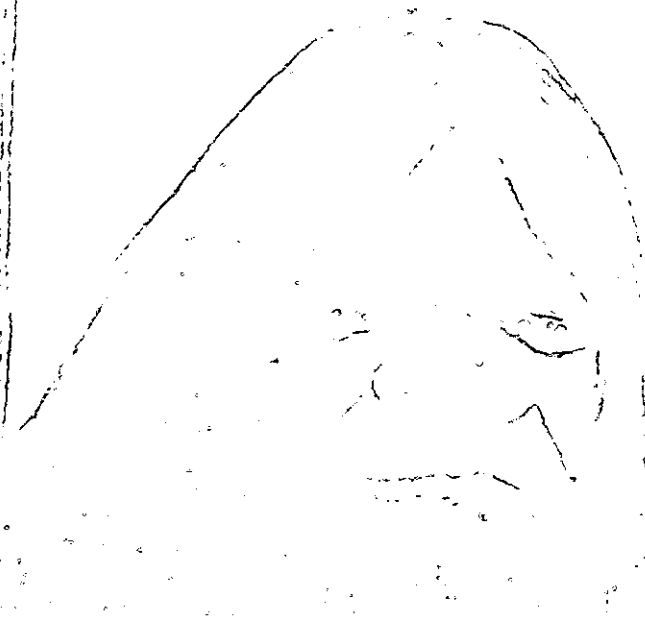
After returning to civilized territory, Pecos Bill became the cowhand who invented all the tricks of the ranching trade. He taught gophers to dig postholes. He invented the branding iron to stop cattle rustling and the cowboy song to soothe the cattle. He killed snakes by feeding them mothballs filled with red pepper and nitroglycerin and, after inventing the lasso, he roped whole herds of cattle at a time. Once he used the entire Rio Grande to water his ranch, which included all of modern day New Mexico.

Pecos Bill used a rattle snake as a whip and rode everything in the West, including a mountain lion and a cyclone. His favorite steed, though, was named Widow-Maker and no one else could ride him. Pecos Bill's bride, Slue-Foot Sue, insisted on riding the horse on their wedding day. Widow-Maker threw Sue, who bounced so high on the hoops of her bridal gown that she hit her head on the moon. Sue bounced for days afterward with no signs of stopping. Pecos Bill realized that she would starve to death, so he shot her. Although Bill was married many times, he never did recover from the loss of Sue.

PECOS BILL



# SASQUATCH



Some involve  
creatures  
that have been  
seen only by an  
unlucky few.



*Sasquatch, also known as Bigfoot, is a half legend / half hoax figure that has been spotted in remote forested areas across America. Stories of Sasquatch sightings have surfaced for centuries, making one wonder if a species of unknown primates could survive undetected within the cracks of the modern world.*

Called by a Native American word meaning “hairy giant,” Sasquatch is renowned for its shy, reclusive nature. It forages for food at night, sleeps during the day and stays out of sight remarkably well given its size.

The beast is not known to be violent, but the humans who have encountered one report that it does pose an assault on the senses. First, the creature is fearsome to see. It stands between seven and eight feet tall and can weigh over 450 lbs. More than 700 footprints attributed to Sasquatch have been collected over the years. They average 15.6 inches long and 7.2 inches wide. Most people who have spotted Bigfoot or its counterparts have described the creature as being half-man/half-ape and having long, dark fur all over its body. Secondly, it is reported to have a very strong, very foul odor. In fact, in Florida, Sasquatch is known as the “Skunk Ape.” Thirdly, the few humans who have heard Sasquatch’s howl, say it is otherworldly. One outdoors writer described it as “The kind of scream no cougar or bear could ever squeeze from their throat...unless it was their last.”

Other tall tales have encouraged the settlement of the American frontier. Perhaps the modern myths of Sasquatch are a reminder that we need not conquer the entire natural world – that its greater mysteries should remain unscathed.



Others are  
mythical sagas  
of true heroes  
passed down by  
generations.



Paul Bunyan and his blue ox, Babe, have been around longer than Pecos Bill. They captured the best traits of the loggers – strength, resourcefulness, dedication, teamwork and productivity. Paul is the hero in a number of stories that end with swaths of land cleared, tamed and improved – and the rewards that go to those who do a job well.

Ordinarily, one stork can deliver several babies to their respective parents' homes. When Paul Bunyan was born, it took five giant storks, working overtime, to carry just him. Paul outgrew his father's clothes in a week and his own clothes were so large his parents used wagon wheels for buttons. A lumber wagon drawn by a team of oxen served as a baby carriage.

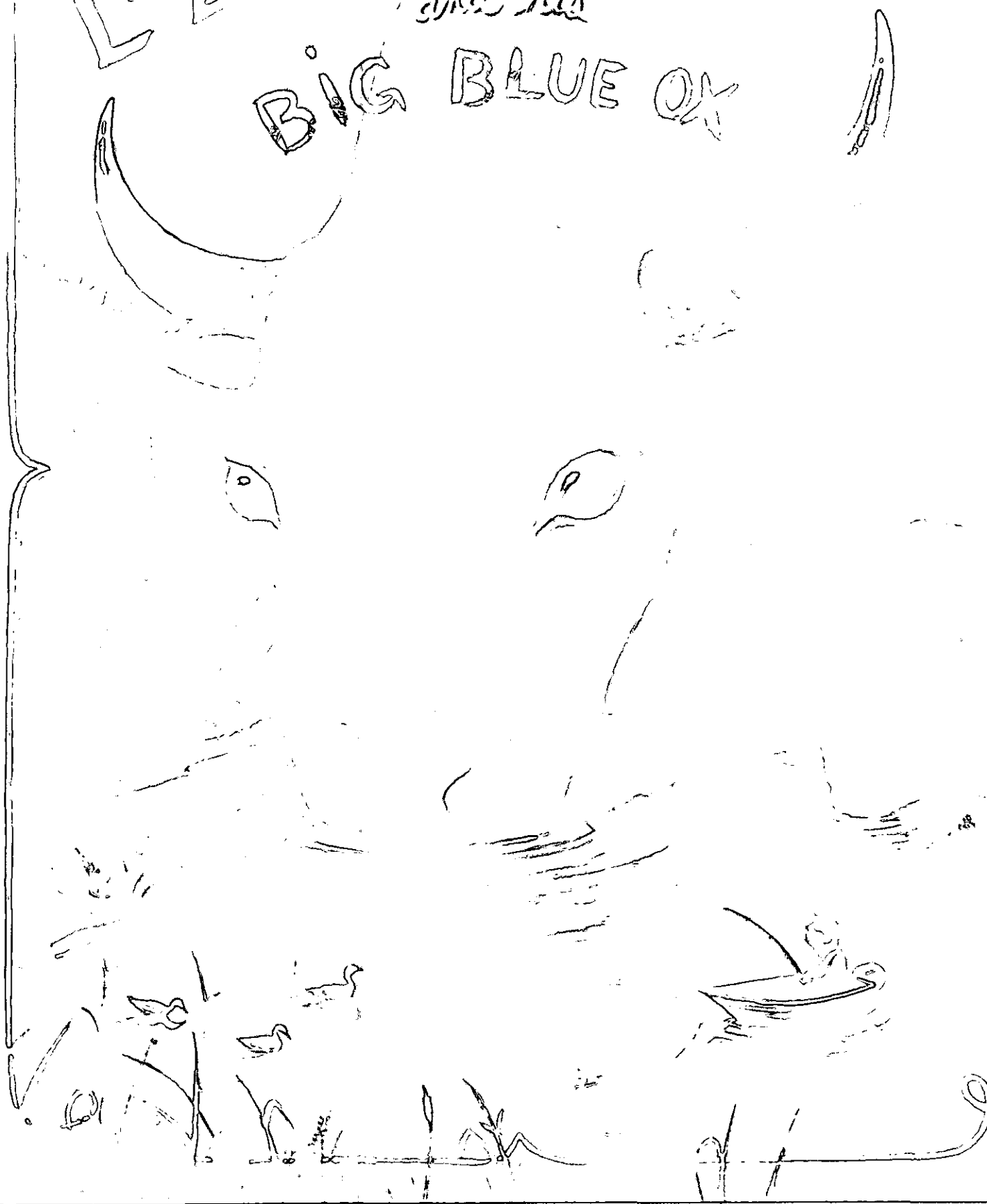
Paul cut his teeth on a peavy pole – used to roll logs – and, as a child, played with an axe and crosscut instead of more traditional toys. On his first birthday his father gave him a blue ox named Babe. Babe grew to be seven axe handles and a plug of tobacco wide between the eyes and, as a snack, would eat 30 bales of hay – wire and all. The tracks that Paul and Babe made gallivanting around Minnesota filled up and made the 10,000 lakes. Their travels took them West, too. They dug the Grand Canyon by dragging Paul's axe behind them, and created Mount Hood by piling rocks on top of their campfire to put it out.

They were famous for being so large – and for putting their weight into their work. Paul Bunyan could fell 23 trees with a single swing of his axe. And when he got his rhythm, he looked like a tornado in a toothpick factory. On one job – clearing North Dakota for Teddy Roosevelt – the winding road to the river slowed the crews. So Paul hooked Babe to the far end, and Babe marched in a straight line until that road ran as true as a crow flies.

# PAUL BUNYAN

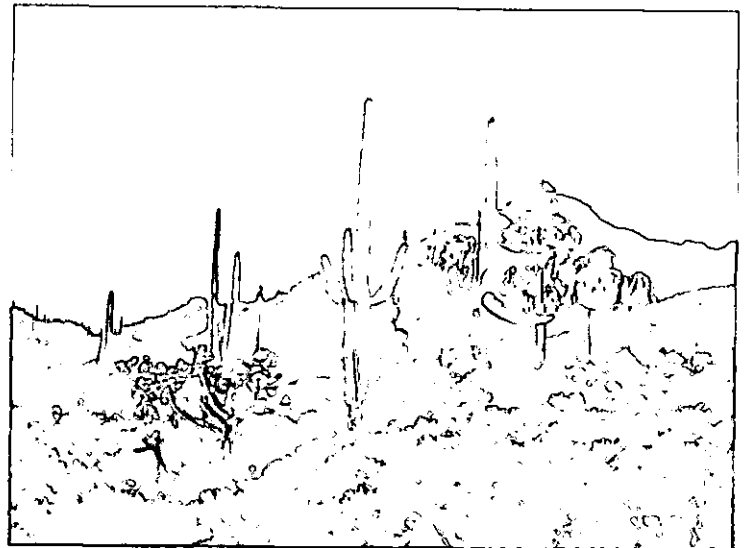
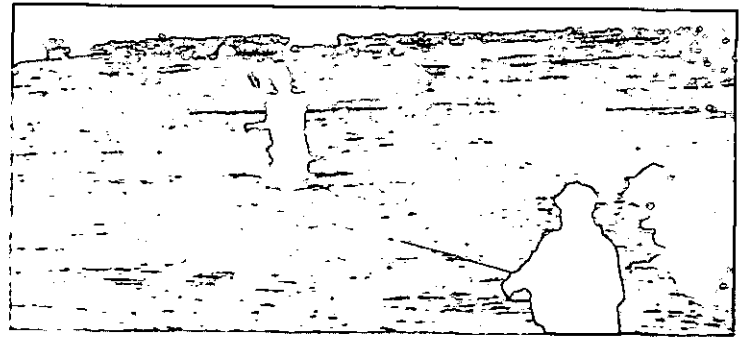
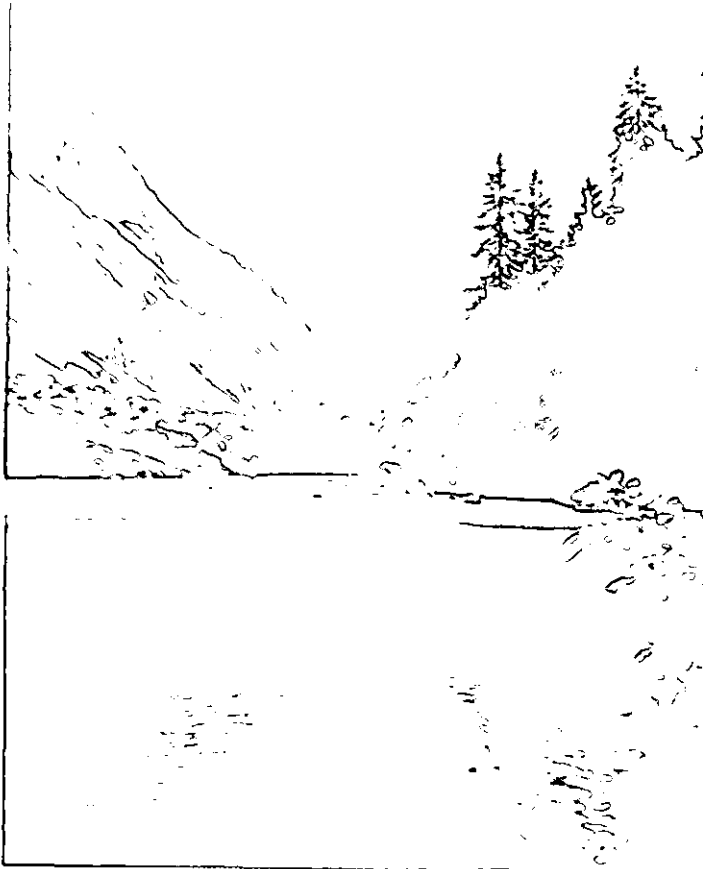
and his

## BIG BLUE OX

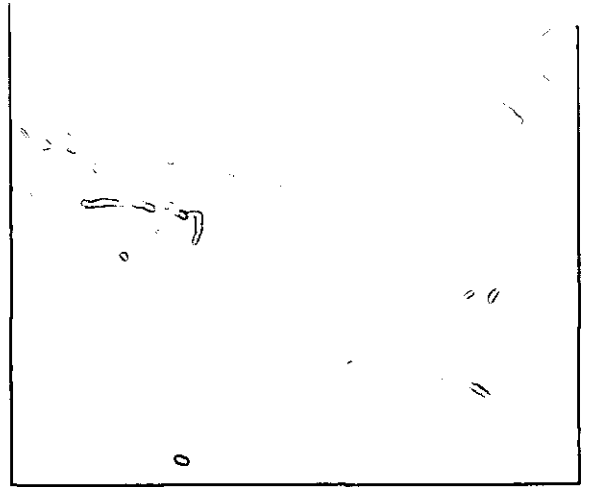
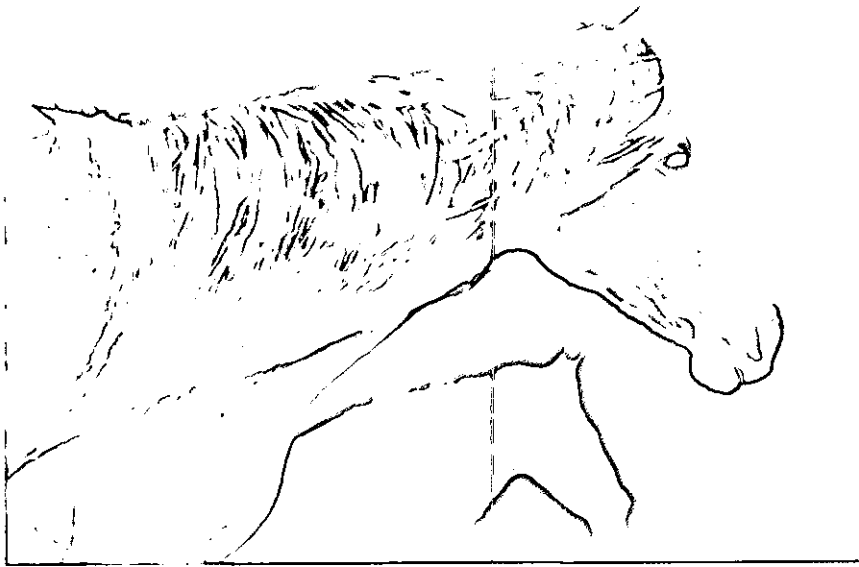


Perhaps the  
best are the true  
stories, told one  
generation to  
the next,

10

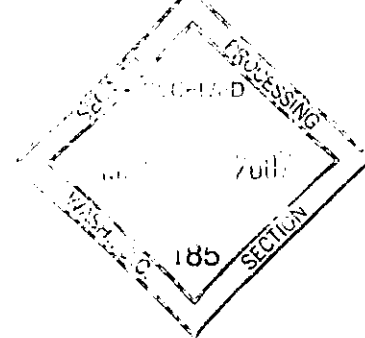


until they  
are weaved into  
the fabric of  
our culture.



While stories  
change with time,  
the joy of sharing  
them remains  
eternal.

Fellow Shareholders,  
As another year passes,  
our story continues.



A marked improvement in operating results and positive movement in the Company's stock price combined for a very encouraging 2006. Much needed rate relief in Arizona, continued customer growth throughout our service areas, and another superb contribution from our pipeline construction subsidiary drove earnings to \$2.07 per share, an increase of \$0.92 per share over the \$1.15 posted in 2005. The Company's stock price was positively affected by the rise in earnings and the strong performance of our industry sector and the overall market.

**Y**ou will recall that the Arizona Corporation Commission (ACC) rendered its decision in the most recent Arizona general rate case in February 2006 and approved an annual increase in operating revenues of \$49.3 million, effective March 1, 2006. While it will take a complete twelve months to capture the full benefit of this increase, that portion realized in 2006 went a long way toward improving the Company's financial results. Unfortunately, we were disappointed that the ACC did not approve the key rate design proposals the Company made to mitigate the effects of weather volatility and customer conservation resulting from higher natural gas prices and more efficient building standards in new construction. And while the weather improved over the prior year, it was still warmer than normal and, consequently, our operating margin in Arizona was negatively impacted.

As we mentioned in last year's report, to bring more stability to revenues and cash flows, the Company proposed several rate design alternatives in each of the most recent general rate cases in California, Nevada and Arizona. In California, the approved rate design substantially protects the authorized operating margin. In Nevada, while the approved rate design mitigates most of the exposure to weather variability, we continue to work with the commission and staff to further refine rate design and improve revenue stability. Although we were allowed to increase the monthly fixed basic service charge to customers in Arizona, the authorized rate design does not yet provide acceptable revenue stability. Fortunately, the ACC's final order acknowledged the need to study this issue further, and the Company was encouraged to continue pursuing rate design refinements with the ACC staff and other interested parties. We have established an ongoing dialogue with all interested parties on this important issue.

14 Effective marketing initiatives emphasizing the lifestyle benefits of natural gas appliances and amenities to builders have enabled the Company to consistently realize a system-wide average market share of new home construction in excess of 90 percent. This compares to an industry average of less than 70 percent.

Having experienced more than a decade of tremendous, near industry leading customer growth, we believe the management of growth has become one of our core competencies. In 2006, we experienced an increase of 71,000 customers throughout our service areas. This organic growth exceeded that of most natural gas distribution companies in the nation. The Company has aggressively managed this growth to ensure it is profitable. As the exclusive provider of natural gas in the areas we serve, we have the obligation to provide service to customers, subject to tariff requirements. However, when the economics for a sub-division do not meet the requirements under our tariffs, we require non-refundable contributions from builders in order to remain within our allowable capital investment. Furthermore, for nearly all residential sub-division developments, we obtain refundable advances from builders to cover the carrying costs of our significant infrastructure investments until meters are set and customers begin paying for service.

**B**ased on the level of current builder commitments for 2007, the torrid growth levels of recent years appear to be moderating. However, given the projected, continued population growth in Arizona and Nevada, we are still anticipating a healthy growth rate going forward. Interestingly, Arizona recently surpassed Nevada as the fastest growing state in the nation in terms of percentage population growth...Nevada is now number two.

We are constantly analyzing our operating activities to improve efficiency and productivity. Through judicious investments in technology, we continue to realize significant improvements. For example, we launched a project this past summer to convert all customer meters to electronic meter reading. Over the past few years, the cost of the required technology decreased to a level that made the economics for the project compelling. The conversion is expected to be completed in 2009 and, through attrition and the use of temporary labor, we expect to complete the conversion with no adverse impact to remaining full-time employees.

During the fifteen years ended 2006, the Company more than doubled, adding 914,000 customers and, notably, only 282 employees...a ratio of 3,241 customers for every employee added. In 2006, we achieved an overall customer to employee ratio of 706 to 1, one of the top productivity ratios in the industry and, by this measure, more than a 50 percent improvement over the last decade. Furthermore, we experienced a decline in our operating costs per customer over the past three years, despite the rising costs of pipeline construction and compliance with new federal and state mandates. Remarkably, at the same time we've experienced these productivity and efficiency gains, the Company consistently achieved a customer satisfaction rating well above 90 percent... a tribute to the commendable efforts of our dedicated employees.

Northern Pipeline Construction Co., our wholly owned pipeline construction subsidiary, continued to post impressive operating results. Through profitable bid work, increased workload under existing contracts, the securing of new contracts and a positive equipment resale market, NPL achieved record net income of \$12.4 million, or \$0.31 per share during 2006. Given the initiatives NPL management has taken, and expected activity for 2007, we anticipate continued favorable operating results, although maybe not at record levels.

As you know, the Company has not increased the dividend on its common stock since 1994. The Board regularly reviews dividend policy and considers the adequacy and sustainability of the Company's earnings and cash flows; the strength of the Company's capital structure; the sustainability of the dividend through all business cycles; and whether the dividend is within a normal payout range for its industry. Based on the recent improvements in the Company's earnings, cash flows and capital structure, the Board of Directors determined that it would be appropriate and in the best interests of the shareholders to increase the dividend on common stock. At the February 27, 2007 Board meeting, the Company's annualized dividend was raised by \$0.04 from \$0.82 per share to \$0.86 per share. The Board will continue to monitor the Company's earnings, cash flows and capital structure with an eye toward the possibility of further enhancing dividend payouts in the future.



**W**e believe 2006 operating results confirm that our principal strategies are working. While we are very encouraged with our progress, there is still improvement to be made. We are determined to build on the momentum of our recent achievements by remaining focused on the following core strategies that have brought us success.

- Continue to work closely with regulators to improve the level and stability of earnings and cash flows
- Continue to aggressively manage growth
- Continue to maximize efficiency and productivity
- Continue to exceed our customers' expectations
- Remain watchful and positioned to seize strategic growth opportunities

As we reflect on the 75-year history of our Company, we have been part of a remarkable story... one that truly is legendary. We acknowledge all those who have contributed toward building a company we can all be proud of. We believe the future is bright. The Board and management are committed to building on that legacy and maintaining and enhancing the value of your investment in Southwest Gas Corporation.



Sincerely,

A handwritten signature in cursive script, reading "LeRoy C. Hanneman, Jr.".

LeRoy C. Hanneman, Jr.  
Chairman of the Board

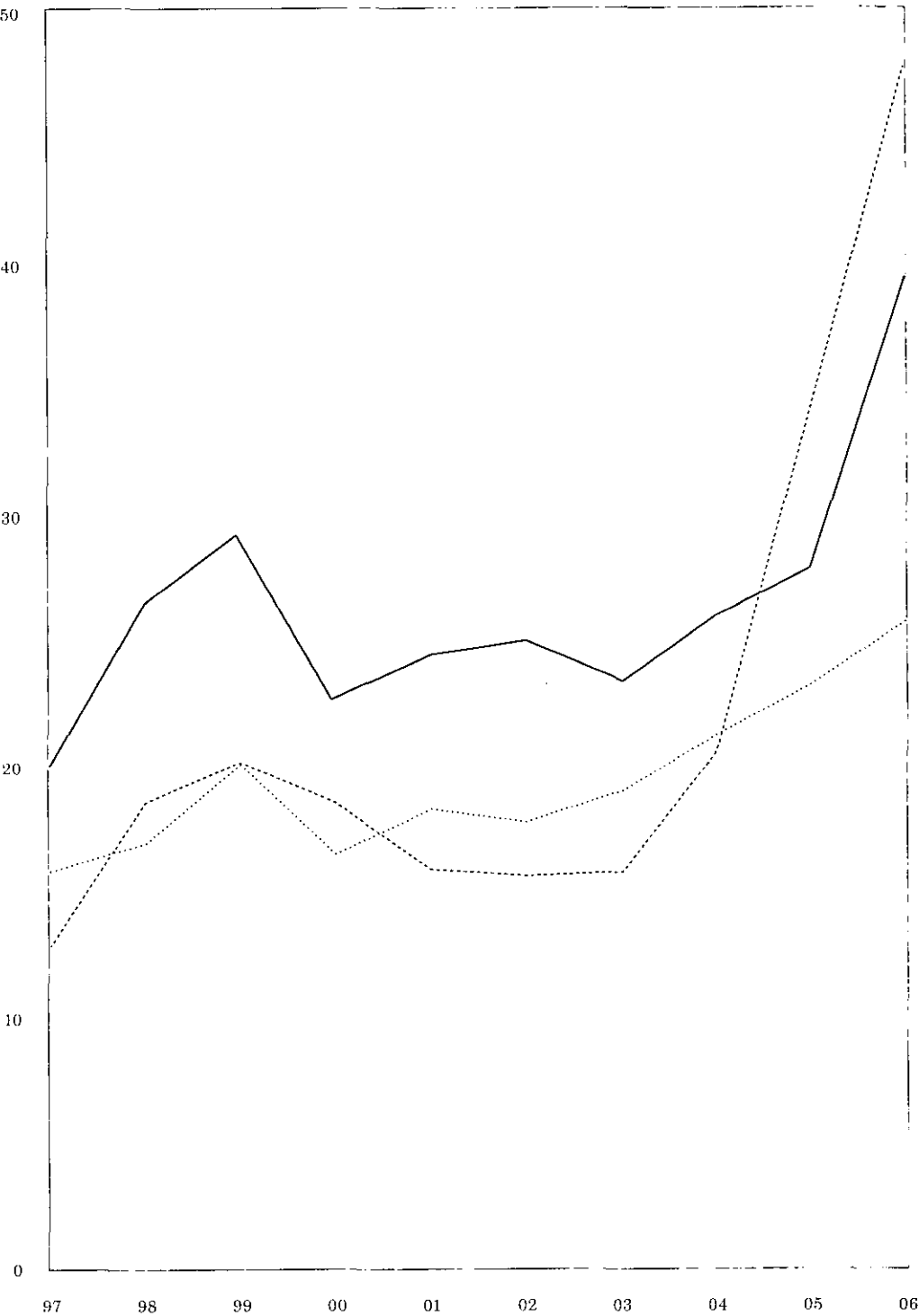
A handwritten signature in cursive script, reading "Jeffery W. Shaw".

Jeffery W. Shaw  
Chief Executive Officer

# Stock Prices & Trading Volume Per Year

stock prices in dollars, volume in millions

- High
- ..... Low
- ..... Volume



Financial Highlights

Throughput (in millions of therms) Sales Transportation Total Combined

2,539	2,467	2,498	2,493	2,440
1,325	1,337	1,258	1,274	1,175
1,214	1,130	1,240	1,219	1,265
02	03	04	05	06

Margin (in thousands of dollars) Sales Transportation Total Combined

				\$693,406
		\$616,286	\$627,126	\$56,301
\$552,521	\$551,850	\$51,033	\$53,928	\$637,105
\$45,983	\$49,387	\$565,253	\$573,198	
\$506,538	\$502,463			
02	03	04	05	06

Market Price Relative to Book Value (in dollars) Book Value Market Price

				\$38.37
\$23.45	\$22.45	\$25.40	\$26.40	
				\$21.58
\$17.91	\$18.42	\$19.48	\$19.10	
02	03	04	05	06

# Financial Highlights

Number of Gas Customers (in thousands)

				1,784
			1,713	
		1,613		
	1,531			
1,455				
02	03	04	05	06

Customers per Employee

				706
			661	
		633		
	600			
571				
02	03	04	05	06

Construction Expenditures Gas Segment (in thousands of dollars)

				\$305,914
		\$274,748		
			\$258,547	
	\$228,288			
\$263,576				
02	03	04	05	06

Customers by Division  
(December 31, 2006)

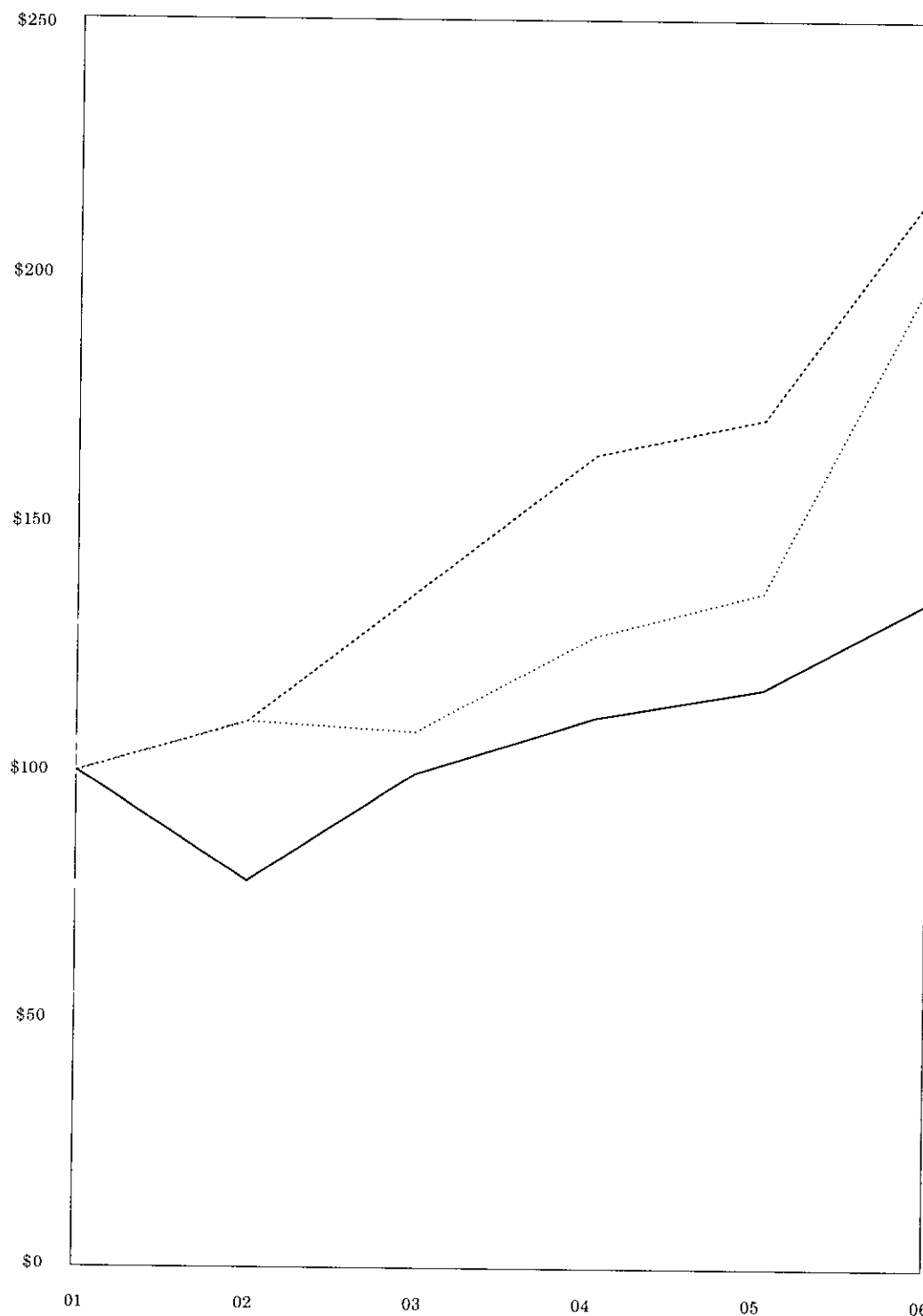
7% Southern California
32% Southern Nevada
8% Northern Nevada
21% Southern Arizona
32% Central Arizona

Margin by Customer Class  
(2006)

67% Residential
18% Small Commercial
3% Large Commercial
9% Transportation
3% Industrial / Other

# Comparison of 5-Year Cumulative Total Returns

..... Southwest Gas  
 — S&P 500  
 ..... S&P Small Cap Gas Index



22

The performance graph above compares the five-year cumulative total return on Company common stock, assuming reinvestment of dividends, with the total returns on the Standard & Poor's 500 Stock Composite Index ("S&P 500") and the S&P Small Cap Gas Index, consisting of the Company and ten other natural gas distribution companies.

(1) The Company is using the S&P Small Cap Gas Index as its peer-group index.

(2) The S&P Small Cap Gas Index, which is weighted by year-end market capitalization, consists of the following companies: Atmos Energy Corp.; Cascade Natural Gas Corp.; Energen Corp.; Laclede Group Inc.; New Jersey Resources Corp.; Northwest Natural Gas Co.; Piedmont Natural Gas Company; South Jersey Industries Inc.; Southern Union Company; the Company; and UGI Corp.

## 2006 Financial Data

<b>Page</b>	<b>Section</b>
24	Consolidated Selected Financial Statistics
26	Management's Discussion and Analysis
38	Consolidated Balance Sheets
39	Consolidated Statements of Income
40	Consolidated Statements of Cash Flows
41	Consolidated Statements of Stockholders' Equity And Comprehensive Income
42	Notes to Consolidated Financial Statements
61	Management's Report on Internal Control Over Financial Reporting
62	Report of Independent Registered Public Accounting Firm



Year Ended December 31,	2006	2005	2004	2003	2002
(Thousands of dollars, except per share amounts)					
Operating revenues	\$2,024,758	\$1,714,283	\$1,477,060	\$1,231,004	\$1,320,909
Operating expenses	1,815,576	1,563,635	1,307,293	1,095,899	1,174,410
Operating income	\$ 209,182	\$ 150,648	\$ 169,767	\$ 135,105	\$ 146,499
Net income	\$ 83,860	\$ 43,823	\$ 56,775	\$ 38,502	\$ 43,965
Total assets at year end	\$3,484,965	\$3,228,426	\$2,938,116	\$2,608,106	\$2,432,928
Capitalization at year end					
Common equity	\$ 901,425	\$ 751,135	\$ 705,676	\$ 630,467	\$ 596,167
Mandatorily redeemable preferred trust securities	—	—	—	—	60,000
Subordinated debentures	100,000	100,000	100,000	100,000	—
Long-term debt	1,286,354	1,224,898	1,162,936	1,121,164	1,092,148
	<u>\$2,287,779</u>	<u>\$2,076,033</u>	<u>\$1,968,612</u>	<u>\$1,851,631</u>	<u>\$1,748,315</u>
Common stock data					
Common equity percentage of capitalization	39.4%	36.2%	35.8%	34.0%	34.1%
Return on average common equity	10.3%	5.9%	8.5%	6.3%	7.5%
Earnings per share	\$ 2.07	\$ 1.15	\$ 1.61	\$ 1.14	\$ 1.33
Diluted earnings per share	\$ 2.05	\$ 1.14	\$ 1.60	\$ 1.13	\$ 1.32
Dividends declared per share	\$ 0.82	\$ 0.82	\$ 0.82	\$ 0.82	\$ 0.82
Payout ratio	40%	71%	51%	72%	62%
Book value per share at year end	\$ 21.58	\$ 19.10	\$ 19.18	\$ 18.42	\$ 17.91
Market value per share at year end	\$ 38.37	\$ 26.40	\$ 25.40	\$ 22.45	\$ 23.45
Market value per share to book value per share	178%	138%	132%	122%	131%
Common shares outstanding at year end (000)	41,770	39,328	36,794	34,232	33,289
Number of common shareholders at year end	23,610	23,571	23,743	22,616	22,119
Ratio of earnings to fixed charges	2.25	1.70	1.93	1.60	1.68

Year Ended December 31,	2006	2005	2004	2003	2002
(Thousands of dollars)					
Sales	\$1,671,093	\$1,401,329	\$1,211,019	\$ 984,966	\$1,069,917
Transportation	56,301	53,928	51,033	49,387	45,983
Operating revenue	1,727,394	1,455,257	1,262,052	1,034,353	1,115,900
Net cost of gas sold	1,033,988	828,131	645,766	482,503	563,379
Operating margin	693,406	627,126	616,286	551,850	552,521
Expenses					
Operations and maintenance	320,803	314,437	290,800	266,862	264,188
Depreciation and amortization	146,654	137,981	130,515	120,791	115,175
Taxes other than income taxes	34,994	39,040	37,669	35,910	34,565
Operating income	\$ 190,955	\$ 135,668	\$ 157,302	\$ 128,287	\$ 138,593
Contribution to consolidated net income	\$ 71,473	\$ 33,670	\$ 48,354	\$ 34,211	\$ 39,228
Total assets at year end	\$3,352,074	\$3,103,804	\$2,843,199	\$2,528,332	\$2,345,407
Net gas plant at year end	\$2,668,104	\$2,489,147	\$2,335,992	\$2,175,736	\$2,034,459
Construction expenditures and property additions	\$ 305,914	\$ 258,547	\$ 274,748	\$ 228,288	\$ 263,576
Cash flow, net					
From operating activities	\$ 248,884	\$ 214,036	\$ 124,135	\$ 187,122	\$ 281,329
From investing activities	(277,980)	(254,120)	(272,458)	(249,300)	(243,373)
From financing activities	20,350	57,763	143,086	60,815	(49,187)
Net change in cash	\$ (8,746)	\$ 17,679	\$ (5,237)	\$ (1,363)	\$ (11,231)
Total throughput (thousands of therms)					
Residential	677,605	650,465	667,174	593,048	588,215
Small commercial	309,856	300,072	303,844	279,154	280,271
Large commercial	128,255	111,839	104,899	100,422	121,500
Industrial/Other	149,243	156,542	163,856	157,305	224,055
Transportation	1,175,238	1,273,964	1,258,265	1,336,901	1,325,149
Total throughput	2,440,197	2,492,882	2,498,038	2,466,830	2,539,190
Weighted average cost of gas purchased (\$/therm)	\$ 0.79	\$ 0.71	\$ 0.57	\$ 0.46	\$ 0.38
Customers at year end	1,784,000	1,713,000	1,613,000	1,531,000	1,455,000
Employees at year end	2,525	2,590	2,548	2,550	2,546
Degree days—actual	1,826	1,735	1,953	1,772	1,912
Degree days—ten-year average	1,961	1,956	1,913	1,931	1,963

## Overview

The following discussion of Southwest Gas Corporation and subsidiaries (the "Company") includes information related to the Company's two business segments: natural gas operations ("Southwest" or the "natural gas operations" segment) and construction services. Southwest is engaged in the business of purchasing, transporting, and distributing natural gas in portions of Arizona, Nevada, and California. Southwest is the largest distributor in Arizona, selling and transporting natural gas in most of central and southern Arizona, including the Phoenix and Tucson metropolitan areas. Southwest is also the largest distributor of natural gas in Nevada, serving the Las Vegas metropolitan area and northern Nevada. In addition, Southwest distributes and transports natural gas in portions of California, including the Lake Tahoe area and the high desert and mountain areas in San Bernardino County.

### Consolidated Results of Operations

Year ended December 31,

(Thousands of dollars, except per share amounts)

#### Contribution to net income

Natural gas operations

Construction services

Consolidated

2006	2005	2004
\$71,473	\$33,670	\$48,354
12,387	10,153	8,421
<u>\$83,860</u>	<u>\$43,823</u>	<u>\$56,775</u>

#### Basic earnings per share

Natural gas operations

Construction services

Consolidated

\$ 1.76	\$ 0.88	\$ 1.37
0.31	0.27	0.24
<u>\$ 2.07</u>	<u>\$ 1.15</u>	<u>\$ 1.61</u>

The main factors contributing to the increase in results of operations during 2006 include:

- higher operating margin resulting from the Arizona general rate increase;
- continued customer growth;
- a nonrecurring property tax settlement;
- increased contribution to net income from NPL; and
- 2005 included a \$10 million pretax charge related to an injuries and damages case (see *Insurance Coverage* for additional information).

Partially offsetting the above positive factors was a 2.4 million increase in average shares outstanding between 2005 and 2006.

#### Principal Factors Affecting Operating Margin

Southwest's operating revenues are recognized from the distribution and transportation of natural gas (and related services) to customers. Operating margin is the measure of gas operating revenues less the net cost of gas sold. Management uses operating margin as a main benchmark in comparing operating results from period to period. The three principal

Northern Pipeline Construction Co. ("NPL" or the "construction services" segment), a wholly owned subsidiary, is a full-service underground piping contractor that provides utility companies with trenching and installation, replacement, and maintenance services for energy distribution systems.

## Executive Summary

The items discussed in this Executive Summary are intended to provide an overview of the results of the Company's operations and are covered in greater detail in later sections of management's discussion and analysis. As reflected in the table below, the natural gas operations segment accounted for an average of 83 percent of consolidated net income over the past three years. As such, management's discussion and analysis is primarily focused on that segment.

factors affecting operating margin are general rate relief, weather, and customer growth.

**General Rate Relief.** Rates charged to customers vary according to customer class and rate jurisdiction and are set by the individual state and federal regulatory commissions that govern Southwest's service territories. Southwest makes periodic filings for rate adjustments as the costs of providing service (including the cost of natural gas purchased) change and as additional investments in new or replacement pipeline and related facilities are made. Rates are intended to provide for recovery of all prudently incurred costs and provide a reasonable return on investment. The mix of fixed and variable components in rates assigned to various customer classes (rate design) can significantly impact the operating margin actually realized by Southwest.

The following events highlight the impact of general rate relief on operating margin during 2006:

- In February 2006, the Arizona Corporation Commission ("ACC") rendered a general rate decision that increased rates in Arizona by \$49.3 million annually effective March 2006. During 2006, general rate relief in Arizona provided a \$35 million increase in operating margin.

- In June 2006, the California Public Utilities Commission ("CPUC") approved the Company's 2006 attrition year filing, granting annualized rate relief of \$3 million, effective April 13, 2006, of which \$2 million was recognized in 2006.

*Weather.* Weather is a significant driver of natural gas volumes used by residential and small commercial customers and is the main reason for volatility in margin. Space heating-related volumes are the primary component of billings for these customer classes and are concentrated in the months of November to April for the majority of the Company's customers. Variances in temperatures from normal levels, especially in Arizona where rates remain leveraged, have a significant impact on the margin and associated net income of the Company. Differences in heating demand, caused primarily by weather variations between 2006 and 2005, accounted for a \$3 million increase in operating margin. Temperatures during both years were warmer than normal.

*Customer Growth.* As of December 31, 2006, Southwest had 1,784,000 residential, commercial, industrial, and other natural gas customers, of which 965,000 customers were located in Arizona, 642,000 in Nevada, and 177,000 in California. Residential and commercial customers represented over 99 percent of the total customer base. During 2006, Southwest added 71,000 customers, a four percent increase, of which 35,000 customers were added in Arizona, 29,000 in Nevada, and 7,000 in California. These additions are largely attributed to population growth in the service areas. Based on current commitments from builders, customer growth is expected to be over four percent in 2007. During 2006, 54 percent of operating margin was earned in Arizona, 36 percent in Nevada, and 10 percent in California. During this same period, Southwest earned 85 percent of operating margin from residential and small commercial customers, 6 percent from other sales customers, and 9 percent from transportation customers. These general patterns are expected to continue.

Incremental margin (\$26 million in 2006) has accompanied this customer growth, but the costs associated with creating and maintaining the infrastructure needed to accommodate these customers have also been significant. The timing of including these costs in rates is often delayed (regulatory lag) and can result in a reduction of current-period earnings.

Management has attempted to mitigate the regulatory lag associated with growth by collecting contributions and advances from home builders and by being judicious in its staffing levels through the effective use of technology. Exemplifying this in recent years has been Southwest's expanded use of electronic meter reading technology. This technology eliminates the need to gain physical access to meters in order to obtain monthly meter readings, thereby reducing the time associated with each meter read while improving their accuracy. By the end of 2006, over 40 percent of Southwest customers' meters were being read electronically. Reductions in staffing levels associated with these efficiencies have been accomplished through normal attrition. Some of

these experienced employees have been redeployed to expand service and construction capabilities. Over the next few years, Southwest will continue to invest in electronic meter reading technology to achieve additional efficiencies.

During the past decade, while adding nearly 692,000 customers, Southwest only increased staffing levels by 105. During this same period, Southwest's customer to employee ratio has climbed from 451/1 to 706/1, an increase of over 50 percent. It has accomplished this without sacrificing service quality. Additional examples of technological improvements over the last few years include electronic order routing, an electronic mapping system and a work management system.

Customer growth requires significant capital outlays for new transmission and distribution plant and results in higher service costs associated with operating and maintaining such facilities. The following financing activities supported continued construction during 2006:

- During 2006, the Company issued 2.4 million shares of common stock through its various stock plans, receiving over \$70 million in proceeds.
- In September 2006, the Company issued \$56 million in Clark County, Nevada 4.75% Industrial Development Revenue Bonds ("IDRBs") Series 2006A. The proceeds from the IDRBs were used by Southwest to expand and upgrade facilities in Clark County, Nevada.
- During 2006, Southwest partially offset capital outlays by collecting approximately \$48.6 million in net advances and contributions from customers and third-party contractors.

The results of the natural gas operations segment and the overall results of the Company are heavily dependent upon the three components noted previously (general rate relief, weather, and customer growth). Significant changes in these components (primarily weather) have contributed to somewhat volatile earnings historically. Management continues to work with its regulatory commissions in designing rate structures that strive to provide affordable and reliable service to its customers while mitigating the volatility in prices to customers and stabilizing returns to investors. Such a rate structure is in place in California and progress has been made in Nevada. Southwest continues to pursue rate design changes in Arizona.

#### *Property Tax Settlement*

In April 2006, a settlement was reached regarding property tax valuation disputes in Arizona for tax years 2001-2005. A decrease to property tax expense of \$3.7 million and an accrual of \$746,000 of interest income was recorded. This entry resulted in nonrecurring after-tax income of approximately \$0.07 per share in 2006.

#### *Natural Gas Price Volatility*

Southwest has experienced price volatility over the past five years, as the weighted-average delivered cost of natural gas

has ranged from a low of 38 cents per therm in 2002 to a high of 79 cents per therm in 2006. Price volatility is expected to continue throughout 2007. Sustained high prices can result in increased under-collected purchased gas adjustment ("PGA") balances and thereby temporarily reduce operating cash flows until rate relief is granted to recover the higher costs. During 2006, Southwest was able to increase gas cost recovery rates in all jurisdictions and has reduced uncollected PGA balances by \$32 million since December 2005.

#### *Stock-Based Compensation*

During the first quarter of 2006, the Company began expensing all stock-based compensation costs. In 2006, gross expense was \$4.9 million including \$1.5 million for stock options and \$3.4 million for performance shares. In 2005, expense related to stock-based compensation (performance shares) was \$4.1 million.

#### *2007 California Attrition Order*

In October 2006, the Company made its 2007 annual California attrition filing requesting a \$2.7 million increase in operating margin. The increase in customer rates was approved to be made effective January 2007. In connection

with this filing, the Company also received approval to change the way operating margin is recognized under the Company's margin tracker mechanism. The change provides for authorized levels of margin to be recognized in equal monthly amounts throughout the year, rather than on a seasonally adjusted basis. This change will not impact the total amount of margin recognized annually; however it will affect the comparability of 2007 versus 2006 quarterly amounts. As a result, the \$2.7 million authorized annual attrition increase to operating margin in 2007, as adjusted for the equalized margin tracker mechanism, is expected to result in the following year-over-year comparative changes (2007 versus 2006): a decrease of \$7.7 million during the first quarter, and increases of \$2.6 million, \$7.4 million and \$400,000 in the second, third and fourth quarters, respectively.

#### *Results of Construction Services Operations*

The Company's construction subsidiary, NPL, increased its contribution to consolidated net income by \$2.2 million in 2006 when compared to the prior year. The increase was primarily due to overall revenue growth, coupled with an improvement in the number of profitable bid jobs, and a sustained favorable equipment resale market in the current year.

### Results of Natural Gas Operations

Year Ended December 31, (Thousands of dollars)	2006	2005	2004
Gas operating revenues	\$1,727,394	\$1,455,257	\$1,262,052
Net cost of gas sold	<u>1,033,988</u>	<u>828,131</u>	<u>645,766</u>
Operating margin	693,406	627,126	616,286
Operations and maintenance expense	320,803	314,437	290,800
Depreciation and amortization	146,654	137,981	130,515
Taxes other than income taxes	<u>34,994</u>	<u>39,040</u>	<u>37,669</u>
Operating income	190,955	135,668	157,302
Other income (expense)	10,049	5,087	1,611
Net interest deductions	85,567	81,595	78,137
Net interest deductions on subordinated debentures	<u>7,724</u>	<u>7,723</u>	<u>7,724</u>
Income before income taxes	107,713	51,437	73,052
Income tax expense	<u>36,240</u>	<u>17,767</u>	<u>24,698</u>
Contribution to consolidated net income	<u>\$ 71,473</u>	<u>\$ 33,670</u>	<u>\$ 48,354</u>

#### *2006 vs. 2005*

Contribution from natural gas operations increased \$37.8 million in 2006 compared to 2005. The improvement in contribution was primarily due to higher operating margin resulting from the Arizona general rate increase, a nonrecurring property tax settlement, and improved other income, partially offset by increased operating expenses and financing costs.

Operating margin increased \$66 million in 2006 as compared to 2005. During 2006, the Company added 71,000 customers,

an increase of four percent. New customers coupled with additional amounts from existing transportation and non-weather sensitive sales customers contributed \$26 million in incremental operating margin. Rate relief in Arizona and California added \$37 million. Differences in heating demand caused primarily by weather variations between periods resulted in a \$3 million operating margin increase as warmer-than-normal temperatures were experienced during both periods (during 2006, operating margin was negatively impacted by \$16 million, while the negative impact in 2005 was \$19 million).

Operations and maintenance expense increased \$6.4 million, or two percent, between periods reflecting general cost increases and incremental operating costs associated with serving additional customers. Factors contributing to the increase included insurance premiums, uncollectible expenses, employee-related costs, and incremental stock-based compensation costs. Operations and maintenance expense for 2005 included a \$10 million nonrecurring provision for an injuries and damages case (see *Insurance Coverage* below for more information).

Depreciation expense increased \$8.7 million, or six percent, as a result of construction activities. Average gas plant in service for 2006 increased \$238 million, or seven percent, compared to 2005. The increase reflects ongoing capital expenditures for the upgrade of existing operating facilities and the expansion of the system to accommodate continued customer growth.

General taxes decreased \$4 million, or 10 percent, primarily as a result of the nonrecurring property tax settlement (see *Property Tax Settlement* for additional information) and Arizona legislation signed in June 2006 that reduced property tax rates, retroactive to January 2006.

Other income (expense) increased \$5 million compared to 2005. The current period includes a \$2 million net increase in interest income primarily associated with the unrecovered balance of deferred purchased gas costs and \$1 million of interest income on the property tax settlement discussed above.

Net financing costs increased \$4 million primarily due to higher rates on variable-rate debt and an increase in average debt outstanding to help finance growth.

Income tax expense in 2006 includes a nonrecurring \$1.7 million state income tax benefit.

#### *2005 vs. 2004*

Contribution from natural gas operations decreased \$14.7 million in 2005 compared to 2004. The decrease was principally the result of higher operating expenses, including a nonrecurring provision for an injuries and damages case, partially offset by improved, but lower than expected, operating margin.

Operating margin increased approximately \$11 million in 2005 as compared to 2004. During 2005, the Company added 81,000 customers (excluding 19,000 customers associated with an acquisition in the South Lake Tahoe area), a growth rate of five percent. New customers contributed \$20 million in incremental margin. Differences in heating demand primarily caused by weather variations between periods resulted in a \$17 million margin decrease as warmer-than-normal temperatures were experienced during 2005, especially in Arizona. Rate relief in California and Nevada provided \$8 million in new operating margin.

Operations and maintenance expense increased \$23.6 million, or eight percent, compared to 2004. A significant component of the variance related to a \$10 million nonrecurring provision for

an injuries and damages case (see *Insurance Coverage* below for more information). The increase also reflected general cost increases and incremental costs associated with providing service to a growing customer base. Factors contributing to the increase included higher insurance premiums, uncollectible expenses, employee-related costs, and compliance costs. Operations and maintenance expense for 2004 included \$2.3 million in lease payments for an LNG facility which was purchased in December 2004.

Depreciation expense and general taxes increased \$8.8 million, or five percent, as a result of construction activities. Average gas plant in service increased \$248 million, or eight percent, as compared to 2004. The increase reflected ongoing capital expenditures for the upgrade of existing operating facilities, the expansion of the system to accommodate continued customer growth, and the purchase of the South Lake Tahoe properties.

Other income (expense) increased \$3.5 million compared to 2004. Returns on long-term investments improved by approximately \$1.2 million during 2005. Other income (expense) for 2005 also included an \$800,000 improvement in interest income primarily associated with the unrecovered balance of deferred purchased gas costs and a \$900,000 increase in the allowance for equity funds used during construction.

Net financing costs rose \$3.5 million, or four percent, between years primarily due to an increase in average debt outstanding to help finance growth and higher rates on variable-rate debt.

Income tax expense in 2004 included \$1.6 million of income tax benefits based on an analysis of current and deferred taxes following the completion of general rate cases and the closure of federal tax year 2000.

#### *Rates and Regulatory Proceedings*

**A**rizona General Rate Case. In February 2006, the ACC rendered a decision on the general rate case filed by Southwest in December 2004. The ACC approved a \$49.3 million increase in operating revenues, effective March 2006. The decision did not include all of the rate design changes or the conservation tracker Southwest had requested. While the ACC did authorize an increase in the customer charge by \$1.70 per month, the rate design approved for commodity sales continues to expose customers, investors and the Company to the risks associated with weather volatility. The ACC did however encourage Southwest to work with the ACC Staff and other interested parties prospectively to seek rate design alternatives that will provide benefits to all affected stakeholders. These collaborative discussions began during the third quarter of 2006 and will continue in the future. Southwest estimates that operating margin in 2006 reflected approximately \$35 million of general rate relief in Arizona.

*California Attrition Filings.* In October 2005, Southwest made its 2006 annual attrition filing requesting a \$4.5 million

increase in operating margin. The effective date of new rates was originally anticipated to be January 2006. The Division of Ratepayer Advocates ("DRA") filed a protest to the attrition filing disagreeing with certain aspects of the Company's calculation. As a result of the protest, the Energy Division suspended the filing. In December 2005, Southwest filed a motion requesting authorization to establish a memorandum account to track the related revenue shortfall between the existing and proposed rates in the attrition filing. The motion was approved effective April 13, 2006. In June 2006, the CPUC approved the revised 2006 attrition retroactive to the date of the memorandum account in April. Annualized rate relief of \$3 million was granted of which approximately \$2 million was recognized in 2006. Although the Company filed an application requesting that the memorandum account be made effective January 2006, consistent with the initial annual filing, this petition was denied during the fourth quarter, and as a result, the Company was unable to recover an estimated \$1 million in operating margin resulting from the delayed effective date.

In October 2006, the Company made its 2007 annual attrition filing requesting a \$2.7 million increase in operating margin. The increase in customer rates was approved to be made effective January 2007. In connection with this filing, the Company also received approval to change the way operating margin is recognized under the Company's margin tracker mechanism. The change provides for authorized levels of margin to be recognized in equal monthly amounts throughout the year, rather than on a seasonally adjusted basis. This change will not impact the total amount of margin recognized annually; however it will affect the comparability of 2007 versus 2006 quarterly amounts. As a result, the \$2.7 million authorized annual attrition increase to operating margin in 2007, as adjusted for the equalized margin tracker mechanism, is expected to result in the following year-over-year comparative changes (2007 versus 2006): a decrease of \$7.7 million during the first quarter, and increases of \$2.6 million, \$7.4 million and \$400,000 in the second, third and fourth quarters, respectively.

*Nevada Weather Normalization Adjustment Provision.* In March 2005, Southwest filed an application requesting the Public Utilities Commission of Nevada ("PUCN") to approve a weather normalization adjustment provision in advance of the Company's next general rate case. This filing requested that winter season billing volumes for weather sensitive customers be adjusted to reflect consumption variations that can be attributed to departures from normal weather. In the second quarter of 2005, the PUCN opened an investigation/rulemaking docket to address the issue of weather normalization, and in November 2005, the PUCN requested additional information. A joint report of the Regulatory Operations Staff and Bureau of Consumer Protection was filed in July 2006 recommending approval of a weather normalization adjustment provision. The PUCN subsequently declined to adopt the recommendation, effectively requiring the issue to be considered in future general rate case proceedings.

## PGA Filings

The rate schedules in all of Southwest's service territories contain provisions that permit adjustments to rates as the cost of purchased gas changes. These deferred energy provisions and purchased gas adjustment clauses are collectively referred to as "PGA" clauses. Filings to change rates in accordance with PGA clauses are subject to audit by state regulatory commission staffs. PGA changes impact cash flows but have no direct impact on profit margin. However, gas cost deferrals and recoveries can impact comparisons between periods of individual income statement components. These include Gas operating revenues, Net cost of gas sold, Net interest deductions and Other income (deductions). In addition, since Southwest is permitted to accrue interest on PGA balances, the cost of incremental PGA-related short-term borrowings will be largely offset, and there should be no material negative impact to earnings.

Southwest had the following outstanding PGA balances receivable at the end of its two most recent fiscal years (millions of dollars):

	2006	2005
Arizona	\$68.4	\$ 46.8
Northern Nevada	1.1	12.6
Southern Nevada	4.1	39.4
California	3.4	10.6
	<u>\$77.0</u>	<u>\$109.4</u>

*Arizona PGA Filings.* In Arizona, Southwest adjusts rates monthly for changes in purchased gas costs, within pre-established limits measured on a twelve-month rolling average. During the first quarter of 2006, the ACC approved an increase in the pre-established limit from \$0.10 to \$0.13 per therm. In addition, the ACC approved the implementation of a temporary PGA surcharge of \$0.11 per therm effective February 2006 to pass through higher costs of natural gas incurred during 2005. The PGA balance in Arizona has been steadily declining after reaching a high of \$95.8 million in April 2006.

*Nevada Deferred Energy Adjustment Filing.* Nevada Senate Bill No. 238, which became effective in October 2005, provides for quarterly gas cost adjustments calculated on a twelve-month rolling average. Adjustments are subject to an annual prudence review and audit of the natural gas costs incurred. This new quarterly adjustment mechanism was effective in allowing Southwest to minimize the PGA balance by year end 2006.

*California Gas Cost Filings.* In California, a monthly gas cost adjustment based on forecasted monthly prices is utilized. Monthly adjustments are designed to provide a more timely recovery of gas costs and to send appropriate pricing signals to customers.

## Other Filings

**El Paso Transmission System.** In June 2005, El Paso Natural Gas Company ("El Paso") filed a general rate case application with the Federal Energy Regulatory Commission ("FERC"). (Southwest is dependent upon El Paso for the transportation of natural gas for virtually all of its Arizona service territories, and through August 2006, part of its southern Nevada service territories.) As part of its application, which is the first since the conversion of full requirements customers like Southwest to contract demand services, El Paso proposed various tariff changes along with new service offerings. The annual increase in gas transportation costs to Southwest was approximately \$19.1 million. The new rates became effective January 2006, subject to refund. However, the implementation of new services and certain overrun and imbalance penalty charges proposed in El Paso's application was phased-in during the period June 2006 through November 2006. In December 2006, El Paso filed a settlement offer with the FERC which would resolve many of the issues raised in the general rate case proceeding. Southwest expects to fully recover any increased costs resulting from a final order or settlement in the case.

## Capital Resources and Liquidity

The capital requirements and resources of the Company generally are determined independently for the natural gas operations and construction services segments. Each business activity is generally responsible for securing its own financing sources. The capital requirements and resources of the construction services segment are not material to the overall capital requirements and resources of the Company.

### *2006 Construction Expenditures*

Southwest continues to experience high customer growth. This growth has required significant capital outlays for new transmission and distribution plant, to keep up with consumer demand. During the three-year period ended December 31, 2006, total gas plant increased from \$3 billion to \$3.8 billion, or at an annual rate of seven percent. Customer growth was the primary reason for the plant increase as Southwest added 253,000 net new customers (including 19,000 customers acquired in the South Lake Tahoe area) during the three-year period.

During 2006, construction expenditures for the natural gas operations segment were \$306 million. Approximately 76 percent of these expenditures represented new construction and the balance represented costs associated with routine replacement of existing transmission, distribution, and general plant. Cash flows from operating activities of Southwest (net of dividends) provided \$215 million of the required capital resources pertaining to total capital expenditures in 2006. The remainder was provided from external financing activities and existing credit facilities.

### *2006 Financing Activity*

The Company has a universal shelf registration statement providing for the issuance and sale of registered securities, which may consist of secured debt, unsecured debt, preferred stock, or common stock. At December 31, 2006, the Company had \$95 million in securities available for issuance under the universal shelf registration statement.

In March 2006, the Company entered into a Sales Agency Financing Agreement with BNY Capital Markets, Inc. relating to the issuance and sale of up to \$45 million aggregate amount of shares of the Company's common stock, from time to time over a three-year period ("Equity Shelf Program"). Sales of the shares are made at market prices prevailing at the time of sale. Net proceeds from the sale of shares of common stock under the Equity Shelf Program are used for general corporate purposes, including the acquisition of property for the construction, completion, extension or improvement of pipeline systems and facilities located in and around the communities Southwest serves. During 2006, approximately 947,000 shares were issued in at-the-market offerings through the Equity Shelf Program at an average price of \$29.87 per share with gross proceeds of \$28.3 million, agent commissions of \$283,000, and net proceeds of \$28 million.

During 2006, the Company issued approximately 1.5 million additional shares of common stock through the Dividend Reinvestment and Stock Purchase Plan ("DRSPP"), Employee Investment Plan, Management Incentive Plan, and Stock Incentive Plan. In addition, in 2006, Southwest offset capital outlays by collecting approximately \$48.6 million in net advances and contributions from third-party contractors.

In September 2006, the Company issued \$56 million in Clark County, Nevada 4.75% IDRBs Series 2006A pursuant to a financing agreement and indenture. The IDRBs were issued at a discount of 0.625% and are due September 1, 2036. The net proceeds from the IDRBs were used by Southwest to expand and upgrade facilities in Clark County, Nevada.

### *2007 Construction Expenditures and Financing*

Southwest estimates construction expenditures during the three-year period ending December 31, 2009 will be approximately \$880 million. Of this amount, approximately \$337 million are expected to be incurred in 2007. During the three-year period, cash flow from operating activities (net of dividends) is estimated to fund over 90 percent of the gas operations' total construction expenditures, assuming timely recovery of currently deferred PGA balances. Southwest also has \$43 million in long-term debt maturities over the three-year period. Maturities would increase to \$50.5 million if an existing bondholder exercises a discretionary put option in 2007. The Company expects to raise \$100 million to \$125 million from its various common stock programs. Any remaining cash requirements are expected to be provided by existing credit facilities and/or other external financing



sources. The timing, types, and amounts of these additional external financings will be dependent on a number of factors, including conditions in the capital markets, timing and amounts of rate relief, growth levels in Southwest service

areas, and earnings. These external financings may include the issuance of both debt and equity securities, bank and other short-term borrowings, and other forms of financing.

### *Contractual Obligations*

Obligations under long-term debt, gas purchase obligations and significant non-cancelable operating leases at December 31, 2006 were as follows (millions of dollars):

	Payments due by period				
	Total	2007	2008-2009	2010-2011	Thereafter
<b>Contractual Obligations</b>					
Subordinated debentures to Southwest					
Gas Capital II (Note 5) (a)	\$ 383	\$ 8	\$ 15	\$ 15	\$ 345
Long-term debt (Note 6) (a)	2,414	102	183	471	1,658
Operating leases (Note 2)	32	5	9	5	13
Gas purchase obligations (b)	519	422	97	—	—
Pipeline capacity (c)	667	105	195	189	178
Other commitments	17	6	6	2	3
<b>Total</b>	<b>\$4,032</b>	<b>\$648</b>	<b>\$505</b>	<b>\$682</b>	<b>\$2,197</b>

(a) Includes scheduled principal and interest payments over the life of the debt.

(b) Includes fixed-price and variable-rate gas purchase contracts covering approximately 140 million dekatherms. Fixed-price contracts range in price from \$6 to \$11 per dekatherm. Variable-price contracts reflect minimum contractual obligations.

(c) Southwest has pipeline capacity contracts for firm transportation service, both on a short- and long-term basis, with several companies for all of its service territories. Southwest also has interruptible contracts in place that allow additional capacity to be acquired should an unforeseen need arise. Costs associated with these pipeline capacity contracts are a component of the cost of gas sold and are recovered from customers primarily through the PGA mechanism.

32

Estimated funding for pension and other postretirement benefits during calendar year 2007 is \$24 million.

### *Liquidity*

Liquidity refers to the ability of an enterprise to generate adequate amounts of cash to meet its cash requirements. Several general factors that could significantly affect liquidity in future years include inflation, growth in Southwest's service territories, changes in the ratemaking policies of regulatory commissions, interest rates, variability of natural gas prices, changes in income tax laws, and the level of Company earnings. Of these factors natural gas prices have had the most significant impact on Company liquidity.

Over the past five years the weighted-average delivered cost of natural gas has ranged from a low of 38 cents per therm in 2002 to a high of 79 cents per therm in 2006. Price volatility is expected to continue throughout 2007. Southwest periodically enters into fixed-price term contracts to mitigate price volatility. About half of Southwest's annual normal weather supply needs are secured using short duration contracts (one year or less). For the 2006/2007 heating season, fixed price contracts ranged in price from \$6 to \$11 per dekatherm. Natural gas purchases not covered by fixed-price contracts are made under variable-price contracts with firm quantities and on the spot market. Prices for these contracts are not known until the month of purchase. Southwest does not currently utilize other stand-alone derivative financial instruments for speculative purposes, or for hedging. During 2007, Southwest

intends to supplement its current volatility mitigation program with stand-alone derivative instruments. The combination of fixed-price contracts and derivative instruments should increase flexibility for Southwest and increase supplier diversification. The costs of such derivative financial instruments are expected to be recovered from customers.

The rate schedules in Southwest's service territories contain PGA clauses which permit adjustments to rates as the cost of purchased gas changes. The PGA mechanism allows Southwest to request to change the gas cost component of the rates charged to its customers to reflect increases or decreases in the price expected to be paid to its suppliers and companies providing interstate pipeline transportation service.

On an interim basis, Southwest generally defers over- or under-collections of gas costs to PGA balancing accounts. In addition, Southwest uses this mechanism to either refund amounts over-collected or recoup amounts under-collected as compared to the price paid for natural gas during the period since the last PGA rate change went into effect. At December 31, 2006, the combined balances in PGA accounts totaled an under-collection of \$77 million versus an under-collection of \$109 million at December 31, 2005. See **PGA Filings** for more information on recent regulatory filings. Southwest has the ability to draw on its \$300 million credit facility to temporarily finance under-collected PGA balances.

This facility runs through April 2011. Southwest has designated \$150 million of the facility as long-term debt and the remaining \$150 million for working capital purposes. Southwest currently believes the \$150 million designated for working capital purposes is adequate to meet liquidity needs. At December 31, 2006, \$147 million was outstanding on the long-term portion and no borrowings were outstanding on the short-term portion of the credit facility.

#### *Off-Balance Sheet Arrangements*

All Company debt is recorded on its balance sheets. The Company has long-term operating leases, which are described in **Note 2—Utility Plant** of the Notes to Consolidated Financial Statements. No debt instruments have credit triggers or other clauses that result in default if Company bond ratings are lowered by rating agencies. Certain Company debt instruments contain securities ratings covenants that, if set in motion, would increase financing costs. See discussion below for the impact of a recent credit rating change.

#### *Securities Ratings*

Securities ratings issued by nationally recognized ratings agencies provide a method for determining the credit worthiness of an issuer. Company debt ratings are important because long-term debt constitutes a significant portion of total capitalization. These debt ratings are a factor considered by lenders when determining the cost of debt for the Company (i.e., the better the rating, the lower the cost to borrow funds).

In May 2006, Moody's Investors Service, Inc. ("Moody's") lowered its rating on the Company's unsecured long-term debt to Baa3 from Baa2 and changed the outlook for the rating to stable from negative. The change in credit rating will result in an annualized estimated increase of \$375,000 in interest expense on existing long-term debt. No debt covenants were affected by the downgrade. Moody's cited a long-term warming trend in the Company's service territories, regulatory lag, and weak credit measures as some of the factors behind the downgrade. Moody's applies a Baa rating to obligations which are considered medium grade obligations with adequate security. A numerical modifier of 1 (high end of the category) through 3 (low end of the category) is included with the Baa to indicate the approximate rank of a company within the range.

The Company's unsecured long-term debt rating from Fitch, Inc. ("Fitch") is BBB. Fitch debt ratings range from AAA (highest credit quality) to D (defaulted debt obligation). The Fitch rating of BBB indicates a credit quality that is considered prudent for investment.

The Company's unsecured long-term debt rating from Standard and Poor's Ratings Services ("S&P") is BBB-. S&P debt ratings range from AAA (highest rating possible) to D

(obligation is in default). The S&P rating of BBB- indicates the debt is regarded as having an adequate capacity to pay interest and repay principal.

A securities rating is not a recommendation to buy, sell, or hold a security and is subject to change or withdrawal at any time by the rating agency.

#### *Inflation*

Results of operations are impacted by inflation. Natural gas, labor, consulting, and construction costs are the categories most significantly impacted by inflation. Changes to cost of gas are generally recovered through PGA mechanisms and do not significantly impact net earnings. Labor is a component of the cost of service, and construction costs are the primary component of rate base. In order to recover increased costs, and earn a fair return on rate base, general rate cases are filed by Southwest, when deemed necessary, for review and approval by regulatory authorities. Regulatory lag, that is, the time between the date increased costs are incurred and the time such increases are recovered through the ratemaking process, can impact earnings. See **Rates and Regulatory Proceedings** for a discussion of recent rate case proceedings.

#### *Insurance Coverage*

The Company maintains liability insurance for various risks associated with the operation of its natural gas pipelines and facilities. In connection with these liability insurance policies, the Company has been responsible for an initial deductible or self-insured retention amount per incident, after which the insurance carriers would be responsible for amounts up to the policy limits. For the policy year August 2004 to July 2005, the self-insured retention amount associated with general liability claims was \$1 million per incident plus payment of the first \$10 million in aggregate claims above \$1 million in the policy year. In May 2005, a leaking natural gas line was involved in a fire that severely injured an individual. The leak is believed to have been caused by a rock impinging upon a natural gas line that was installed for Southwest Gas and that is owned and operated by the Company. In December 2005, the plaintiffs filed a complaint against the Company claiming \$3.4 million in medical bills, \$12 million in future medical expenses, and unspecified claims for general and punitive damages. By December 2005, the Company had recorded a total liability related to this incident equal to the Company's maximum self-insured retention level of \$11 million. In the fourth quarter of 2006, the case was settled. The amount of the settlement that exceeded \$11 million was covered by insurance. The Company's current insurance contracts limit the self-insured retention to \$1 million per incident plus payment of the first \$5 million in aggregate claims above \$1 million.

## Results of Construction Services

Year Ended December 31,	2006	2005	2004
(Thousands of dollars)			
Construction revenues	\$297,364	\$259,026	\$215,008
Cost of construction	271,743	237,356	196,792
Gross profit	25,621	21,670	18,216
General and administrative expenses	7,377	6,672	5,742
Operating income	18,244	14,998	12,474
Other income (expense)	4,086	3,009	2,131
Interest expense	1,686	1,009	645
Income before income taxes	20,644	16,998	13,960
Income tax expense	8,257	6,845	5,539
Contribution to consolidated net income	<u>\$ 12,387</u>	<u>\$ 10,153</u>	<u>\$ 8,421</u>

### 2006 vs. 2005

The 2006 contribution to consolidated net income from construction services increased \$2.2 million from 2005. The factors that drove the favorable results include a 15 percent increase in revenues, an improvement in the number of profitable bid jobs, and a favorable equipment resale market.

Revenues increased \$38 million due primarily to an increased workload under several existing contracts and an improvement in the amount and profitability of new bid work. Gross profit increased approximately \$4 million, or 18 percent, as a direct result of the increase in revenues. The construction revenues above include NPL contracts with Southwest totaling \$80.6 million in 2006, \$71.8 million in 2005, and \$61.6 million in 2004. NPL accounts for the services provided to Southwest at contractual (market) prices.

General and administrative costs increased \$705,000 due primarily to incremental costs associated with growth including labor and other administrative expenses. Other income increased \$1.1 million as a result of an increase in gains on sale of equipment. Interest expense increased \$677,000 due to additional long-term borrowing for the purchase of new equipment and higher interest rates.

Construction activity is cyclical and can be significantly impacted by changes in general and local economic conditions, including interest rates, employment levels, job growth, and

local and federal tax rates. The slow-down in construction activities observed in regional and national markets at the end of 2006, if sustained, could negatively impact the amount of work received under existing blanket contracts, the amount of bid work, and the equipment resale market in 2007.

### 2005 vs. 2004

The 2005 contribution to consolidated net income from construction services increased \$1.7 million from 2004. The increase was primarily due to overall revenue growth, coupled with an improvement in the number of profitable bid jobs and a favorable equipment resale market in 2005.

Revenues and gross profit for 2005 reflect an increased workload under existing contracts and an increase in the quantity and profitability of bid work. Favorable working conditions in several operating areas facilitated additional construction activity.

General and administrative costs increased \$930,000 due primarily to the depreciation expense related to the implementation of new computer systems and compliance costs. Other income (expense) increased \$878,000 as a result of an increase in gains on sale of equipment. Interest expense rose \$364,000 due to additional long-term borrowing for the purchase of new equipment and higher interest rates.

## Recently Issued Accounting Pronouncements

Below is a listing of recently issued accounting pronouncements by the Financial Accounting Standards Board ("FASB"). See **Note 1—Summary of Significant Accounting Policies** for more information regarding these accounting pronouncements and their potential impact on the Company's financial position and results of operations.

Title	Month of Issue	Effective Date
<b>SFAS No. 155</b> , "Accounting for Certain Hybrid Financial Instruments—an amendment of FASB Statements No. 133 and 140."	February 2006	January 2007
<b>SFAS No. 156</b> , "Accounting for Servicing of Financial Assets—an amendment of FASB Statement No. 140."	March 2006	January 2007
<b>FIN No. 48</b> , "Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109."	June 2006	January 2007
<b>SFAS No. 157</b> , "Fair Value Measurements."	September 2006	January 2008

### Application of Critical Accounting Policies

A critical accounting policy is one which is very important to the portrayal of the financial condition and results of a company, and requires the most difficult, subjective, or complex judgments of management. The need to make estimates about the effect of items that are uncertain is what makes these judgments difficult, subjective, and/or complex. Management makes subjective judgments about the accounting and regulatory treatment of many items and bases its estimates on historical experience and on various other assumptions that it believes to be reasonable under the circumstances, the results of which form the basis for making judgments. These estimates may change as new events occur, as more experience is acquired, as additional information is obtained, and as the Company's operating environment changes. The following are accounting policies that are critical to the financial statements of the Company. For more information regarding the significant accounting policies of the Company, see **Note 1—Summary of Significant Accounting Policies**.

#### *Regulatory Accounting*

Natural gas operations are subject to the regulation of the Arizona Corporation Commission, the Public Utilities Commission of Nevada, the California Public Utilities Commission, and the Federal Energy Regulatory Commission. The accounting policies of the Company conform to generally accepted accounting principles applicable to rate-regulated enterprises (including SFAS No. 71 "Accounting for the Effects of Certain Types of Regulation") and reflect the effects of the ratemaking process. As such, the Company is allowed to defer as regulatory assets, costs that otherwise would be expensed if it is probable that future recovery from customers will occur. The Company reviews these assets to assess their ultimate recoverability within the approved regulatory guidelines. If rate recovery is no longer probable, due to competition or the actions of regulators, the Company is required to write-off the related regulatory asset (which would be recognized as current-period expense).

Regulatory liabilities are recorded if it is probable that revenues will be reduced for amounts that will be credited to customers through the ratemaking process. The timing and inclusion of costs in rates is often delayed (regulatory lag) and results in a reduction of current-period earnings. Refer to **Note 4—Regulatory Assets and Liabilities** for a list of regulatory assets and liabilities.

#### *Unbilled Revenues*

Revenues related to the sale and/or delivery of natural gas are generally recorded when natural gas is delivered to customers. However, the determination of natural gas sales to individual customers is based on the reading of their meters, which is performed on a systematic basis throughout the month. At the end of each month, revenues for natural gas that has been delivered but not yet billed are accrued. This unbilled revenue is estimated each month based on daily sales volumes, applicable rates, analyses reflecting significant historical trends, weather, and experience. In periods of extreme weather conditions, the interplay of these assumptions could impact the variability of the unbilled revenue estimates.

#### *Accounting for Income Taxes*

The income tax calculations of the Company require estimates due to known future tax rate changes, book to tax differences, and uncertainty with respect to regulatory treatment of certain property items. The Company uses the asset and liability method of accounting for income taxes. Under the asset and liability method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Regulatory tax assets and liabilities are recorded to the extent the Company believes they will be recoverable from or refunded to customers in future rates. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The Company regularly assesses financial

statement tax provisions and adjusts the tax provisions when necessary as additional information is obtained. A change in the regulatory treatment or significant changes in tax-related estimates, assumptions, or enacted tax rates could have a material impact on cash flows, the financial position, and/or results of operations of the Company.

#### *Accounting for Pensions and Other Postretirement Benefits*

Southwest has a noncontributory qualified retirement plan with defined benefits covering substantially all employees. In addition, Southwest has a separate unfunded supplemental retirement plan which is limited to officers. The Company's pension obligations and costs for these plans are affected by the amount of cash contributions to the plans, the return on plan assets, discount rates, and by employee demographics, including age, compensation, and length of service. Changes made to the provisions of the plans may also impact current and future pension costs. Actuarial formulas are used in the determination of pension obligations and costs and are affected by actual plan experience and assumptions about future experience. Key actuarial assumptions include the expected return on plan assets, the discount rate used in determining the projected benefit obligation and pension costs, and the assumed rate of increase in employee compensation. Relatively small changes in these assumptions (particularly the discount rate) may significantly affect pension obligations and costs for these plans.

Due to an increase in market interest rates for high-quality fixed income investments, the Company raised the discount rate to 6.00% at December 31, 2006 from 5.75% at December 31, 2005. The weighted-average rate of compensation increase was raised to 3.75% from 3.30%. The Company maintained its asset return assumption for 2007 at 8.50%. These offsetting changes will not result in a significant change in pension expense for 2007. Should interest rates rise in 2007, future pension expense and projected benefit obligations could decrease. Conversely, declining interest rates would put upward pressure on future pension expense and projected benefit obligations.

In September 2006, the FASB issued SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB Statements No. 87, 88, 106, and 132(R)", which requires employers to recognize the overfunded or underfunded positions of defined benefit postretirement plans, including pension plans, in their balance sheets. Under SFAS No. 158, any actuarial gains and losses, prior service costs and transition assets or obligations that were not recognized under previous accounting standards must be recognized in accumulated other comprehensive income under stockholders' equity, net of tax, until they are amortized as a component of net periodic benefit cost. SFAS No. 158 does not change how net periodic pension and postretirement costs are accounted for and reported in the income statement. The Company adopted the provisions of SFAS No. 158 effective December 31, 2006.

In accordance with SFAS No. 71, the Company has established a regulatory asset for the portion of the total amounts otherwise chargeable to accumulated other comprehensive income that are expected to be recovered through rates in future periods. The changes in actuarial losses and prior service credits pertaining to the regulatory asset will be recognized as an adjustment to the regulatory asset account as these amounts are recognized as components of net periodic pension costs each year. See **Note 9—Pension and Other Postretirement Benefits** for plan assumptions and further discussion of the impact of adopting SFAS No. 158.

Management believes that regulation and the effects of regulatory accounting have the most significant impact on the financial statements. When Southwest files rate cases, capital assets, costs, and gas purchasing practices are subject to review, and disallowances can occur. Regulatory disallowances in the past have not been frequent but have on occasion been significant to the operating results of the Company.

#### *Certifications*

The SEC requires the Company to file certifications of its Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO") regarding reporting accuracy, disclosure controls and procedures, and internal control over financial reporting as exhibits to the Company's periodic filings. The CEO and CFO certifications for the period ended December 31, 2006 were included as exhibits to the 2006 Annual Report on Form 10-K which was filed with the SEC. The Company is also required to file an annual CEO certification regarding corporate governance listing standards compliance with the New York Stock Exchange ("NYSE"). The most recent annual CEO certification, dated May 10, 2006, was filed with the NYSE in May 2006.

#### *Forward-Looking Statements*

This annual report contains statements which constitute "forward-looking statements" within the meaning of the Securities Litigation Reform Act of 1995 ("Reform Act"). All statements other than statements of historical fact included or incorporated by reference in this annual report are forward-looking statements, including, without limitation, statements regarding the Company's plans, objectives, goals, projections, strategies, future events or performance, and underlying assumptions. The words "may," "will," "should," "could," "expect," "plan," "anticipate," "believe," "estimate," "predict," "continue," and similar words and expressions are generally used and intended to identify forward-looking statements. In particular, statements regarding customer growth, estimated construction expenditures, the sources and amounts of financing, customer mix and revenue patterns, efficiencies resulting from new technology, construction services contribution, ability to receive more effective rate designs, the expected results of the projected impact in 2007 due to changes in the margin tracker mechanism, sufficiency of working

capital and ability to raise funds and receive external financing, and statements regarding future gas prices, future PGA balances, the effects of recent accounting pronouncements, and the timing and results of future rate approvals and guidelines are forward-looking statements. All forward-looking statements are intended to be subject to the safe harbor protection provided by the Reform Act.

A number of important factors affecting the business and financial results of the Company could cause actual results to differ materially from those stated in the forward-looking statements. These factors include, but are not limited to, the impact of weather variations on customer usage, customer growth rates, changes in natural gas prices, our ability to recover costs through our PGA mechanism, the effects of regulation/deregulation, the timing and amount of rate relief, changes in rate design, changes in gas procurement practices, changes in capital requirements and funding, the impact of conditions in the capital markets on financing costs, changes in construction expenditures and financing, renewal of franchises, easements and rights-of-way, changes in operations

and maintenance expenses, effects of accounting changes, future liability claims, changes in pipeline capacity for the transportation of gas and related costs, acquisitions and management's plans related thereto, competition, and our ability to raise capital in external financings. In addition, the Company can provide no assurance that its discussions regarding certain trends relating to its financing, operations and maintenance expenses will continue in future periods. For additional information on the risks associated with the Company's business, see **Item 1A. Risk Factors** in the Company's Annual Report on Form 10-K for the year ended December 31, 2006.

All forward-looking statements in this annual report are made as of the date hereof, based on information available to the Company as of the date hereof, and the Company assumes no obligation to update or revise any of its forward-looking statements even if experience or future changes show that the indicated results or events will not be realized. **We caution you not to unduly rely on any forward-looking statement(s).**

## Common Stock Price and Dividend Information

	2006		2005		Dividends Declared	
	High	Low	High	Low	2006	2005
First quarter	\$29.04	\$26.09	\$26.13	\$23.66	\$0.205	\$0.205
Second quarter	31.43	26.46	26.35	23.53	0.205	0.205
Third quarter	34.19	30.70	28.07	25.00	0.205	0.205
Fourth quarter	39.37	32.80	27.86	25.12	0.205	0.205
					<u>\$0.820</u>	<u>\$0.820</u>

The principal market on which the common stock of the Company is traded is the New York Stock Exchange. At February 15, 2007, there were 23,306 holders of record of common stock, and the market price of the common stock was \$38.80.

The Company has a common stock dividend policy which states that common stock dividends will be paid at a prudent level that is within the normal dividend payout range for its

respective businesses, and that the dividend will be established at a level considered sustainable in order to minimize business risk and maintain a strong capital structure throughout all economic cycles. The quarterly common stock dividend was 20.5 cents per share throughout 2006. The dividend of 20.5 cents per share has been paid quarterly since September 1994. In February 2007, the Board of Directors increased the quarterly dividend payout to 21.5 cents per share, effective with the June 2007 payment.

December 31,

2006 2005

(Thousands of dollars, except par value)

**ASSETS**

## Utility plant:

Gas plant

\$ 3,763,310 \$ 3,516,587

Less: accumulated depreciation

(1,175,600) (1,083,900)

Acquisition adjustments, net

1,992 2,173

Construction work in progress

78,402 54,287

Net utility plant (Note 2)

2,668,104 2,489,147

Other property and investments

136,242 118,094

## Current assets:

Cash and cash equivalents

18,786 29,603

Accounts receivable, net of allowances (Note 3)

225,928 198,081

Accrued utility revenue

73,300 68,400

Deferred purchased gas costs (Note 4)

77,007 109,415

Prepays and other current assets (Note 4)

106,603 137,161

Total current assets

501,624 542,660

Deferred charges and other assets (Note 4)

178,995 78,525

Total assets

\$ 3,484,965 \$ 3,228,426

**CAPITALIZATION AND LIABILITIES**

## Capitalization:

Common stock, \$1 par (authorized—45,000,000 shares; issued and outstanding—41,770,291 and 39,328,291 shares) (Note 10)

\$ 43,400 \$ 40,958

Additional paid-in capital

698,258 628,248

Accumulated other comprehensive income (loss), net (Note 9)

(13,666) (41,645)

Retained earnings

173,433 123,574

Total equity

901,425 751,135

Subordinated debentures due to Southwest Gas Capital II (Note 5)

100,000 100,000

Long-term debt, less current maturities (Note 6)

1,286,354 1,224,898

Total capitalization

2,287,779 2,076,033

Commitments and contingencies (Note 8)

## Current liabilities:

Current maturities of long-term debt (Note 6)

27,545 83,215

Short-term debt (Note 7)

— 24,000

Accounts payable

265,739 259,476

Customer deposits

64,151 57,552

Accrued general taxes

45,895 40,526

Accrued interest

21,362 22,472

Deferred income taxes (Note 11)

15,471 68,166

Other current liabilities

55,901 65,546

Total current liabilities

496,064 620,953

Deferred income taxes and other credits:

Deferred income taxes and investment tax credits (Note 11)

308,493 234,739

Taxes payable

5,951 7,551

Accumulated removal costs (Note 4)

125,000 105,000

Other deferred credits (Note 9)

261,678 184,150

Total deferred income taxes and other credits

701,122 531,440

Total capitalization and liabilities

\$ 3,484,965 \$ 3,228,426

The accompanying notes are an integral part of these statements.

Year Ended December 31,	2006	2005	2004
(In thousands, except per share amounts)			
Operating revenues:			
Gas operating revenues	\$1,727,394	\$1,455,257	\$1,262,052
Construction revenues	297,364	259,026	215,008
Total operating revenues	<u>2,024,758</u>	<u>1,714,283</u>	<u>1,477,060</u>
Operating expenses:			
Net cost of gas sold	1,033,988	828,131	645,766
Operations and maintenance	320,803	314,437	290,800
Depreciation and amortization	168,964	156,253	146,018
Taxes other than income taxes	34,994	39,040	37,669
Construction expenses	256,827	225,774	187,040
Total operating expenses	<u>1,815,576</u>	<u>1,563,635</u>	<u>1,307,293</u>
Operating income	<u>209,182</u>	<u>150,648</u>	<u>169,767</u>
Other income and (expenses):			
Net interest deductions	(87,253)	(82,604)	(78,782)
Net interest deductions on subordinated debentures (Note 5)	(7,724)	(7,723)	(7,724)
Other income (deductions)	14,152	8,114	3,751
Total other income and (expenses)	<u>(80,825)</u>	<u>(82,213)</u>	<u>(82,755)</u>
Income before income taxes	128,357	68,435	87,012
Income tax expense (Note 11)	44,497	24,612	30,237
Net income	<u>\$ 83,860</u>	<u>\$ 43,823</u>	<u>\$ 56,775</u>
Basic earnings per share (Note 13)	<u>\$ 2.07</u>	<u>\$ 1.15</u>	<u>\$ 1.61</u>
Diluted earnings per share (Note 13)	<u>\$ 2.05</u>	<u>\$ 1.14</u>	<u>\$ 1.60</u>
Average number of common shares outstanding	40,566	38,132	35,204
Average shares outstanding (assuming dilution)	40,975	38,467	35,488

The accompanying notes are an integral part of these statements.



Year Ended December 31,

(Thousands of dollars)

2006

2005

2004

**CASH FLOW FROM OPERATING ACTIVITIES:**

Net income	\$ 83,860	\$ 43,823	\$ 56,775
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	168,964	156,253	146,018
Deferred income taxes	3,909	(5,514)	38,001
Changes in current assets and liabilities:			
Accounts receivable, net of allowances	(27,847)	(20,216)	(49,307)
Accrued utility revenue	(4,900)	982	(1,500)
Deferred purchased gas costs	32,408	(25,865)	(72,925)
Accounts payable	6,263	92,021	55,758
Accrued taxes	3,198	5,716	3,027
Other current assets and liabilities	24,156	(23,000)	(25,406)
Other	(8,657)	13,424	1,050
Net cash provided by operating activities	<u>281,354</u>	<u>237,624</u>	<u>151,491</u>

**CASH FLOW FROM INVESTING ACTIVITIES:**

Construction expenditures and property additions	(345,325)	(294,369)	(302,688)
Other	33,199	1,985	6,106
Net cash used in investing activities	<u>(312,126)</u>	<u>(292,384)</u>	<u>(296,582)</u>

**CASH FLOW FROM FINANCING ACTIVITIES:**

Issuance of common stock, net	72,452	64,136	58,687
Dividends paid	(33,500)	(31,228)	(28,836)
Issuance of long-term debt, net	92,400	145,256	147,135
Retirement of long-term debt	(84,397)	(31,442)	(83,437)
Temporary changes in long-term debt	(3,000)	—	—
Change in short-term debt	(24,000)	(76,000)	48,000
Net cash provided by financing activities	<u>19,955</u>	<u>70,722</u>	<u>141,549</u>
Change in cash and cash equivalents	(10,817)	15,962	(3,542)
Cash at beginning of period	29,603	13,641	17,183
Cash at end of period	<u>\$ 18,786</u>	<u>\$ 29,603</u>	<u>\$ 13,641</u>
Supplemental information:			
Interest paid, net of amounts capitalized	<u>\$ 92,533</u>	<u>\$ 86,465</u>	<u>\$ 80,433</u>
Income taxes paid (received), net	<u>\$ 39,682</u>	<u>\$ 5,977</u>	<u>\$ (12,640)</u>

The accompanying notes are an integral part of these statements.

# Comprehensive Income

	Common Stock		Additional Paid-in Capital	Accumulated Other Comprehensive Income (Loss)	Retained Earnings	Total	Comprehensive Income (Loss)
	Shares	Amount					
(In thousands, except per share amounts)							
<b>DECEMBER 31, 2003</b>	34,232	\$35,862	\$510,521	\$ —	\$ 84,084	\$630,467	
Common stock issuances	2,562	2,562	56,125			58,687	
Net income					56,775	56,775	\$ 56,775
Additional minimum pension liability adjustment, net of \$6.5 million of tax (Note 9)				(10,892)		(10,892)	(10,892)
Dividends declared							
Common: \$0.82 per share					(29,361)	(29,361)	
2004 Comprehensive Income							<u>\$ 45,883</u>
<b>DECEMBER 31, 2004</b>	36,794	38,424	566,646	(10,892)	111,498	705,676	
Common stock issuances	2,534	2,534	61,602			64,136	
Net income					43,823	43,823	\$ 43,823
Additional minimum pension liability adjustment, net of \$19 million of tax (Note 9)				(30,753)		(30,753)	(30,753)
Dividends declared							
Common: \$0.82 per share					(31,747)	(31,747)	
2005 Comprehensive Income							<u>\$ 13,070</u>
<b>DECEMBER 31, 2005</b>	39,328	40,958	628,248	(41,645)	123,574	751,135	
Common stock issuances	2,442	2,442	70,010			72,452	
Net income					83,860	83,860	\$ 83,860
Additional minimum pension liability adjustment, net of \$20.3 million of tax (Note 9)				33,047		33,047	33,047
Net adjustment to adopt SFAS No. 158, net of \$3.1 million of tax (Note 9)				(5,068)		(5,068)	
Dividends declared							
Common: \$0.82 per share					(34,001)	(34,001)	
2006 Comprehensive Income							<u>\$116,907</u>
<b>DECEMBER 31, 2006</b>	41,770*	\$43,400	\$698,258	\$(13,666)	\$173,433	\$901,425	

\* At December 31, 2006, 1.3 million common shares were registered and available for issuance under provisions of the Employee Investment Plan and the Dividend Reinvestment and Stock Purchase Plan. In addition, 1 million common shares are registered for issuance upon the exercise of options granted under the Stock Incentive Plan (see Note 10). During 2006, approximately 947,000 shares were issued in at-the-market offerings through the Equity Shelf Program with gross proceeds of \$28.3 million, agent commissions of \$283,000, and net proceeds of \$28 million.

The accompanying notes are an integral part of these statements.

**Nature of Operations.** Southwest Gas Corporation (the "Company") is composed of two segments: natural gas operations ("Southwest" or the "natural gas operations" segment) and construction services. Southwest is engaged in the business of purchasing, distributing and transporting natural gas to customers in portions of Arizona, Nevada, and California. The public utility rates, practices, facilities, and service territories of Southwest are subject to regulatory oversight. Natural gas purchases and the timing of related recoveries can materially impact liquidity. Northern Pipeline Construction Co. ("NPL" or the "construction services" segment), a wholly owned subsidiary, is a full-service underground piping contractor that provides utility companies with trenching and installation, replacement, and maintenance services for energy distribution systems.

**Basis of Presentation.** The Company follows generally accepted accounting principles ("GAAP") in accounting for all of its businesses. Accounting for the natural gas utility operations conforms with GAAP as applied to regulated companies and as prescribed by federal agencies and the commissions of the various states in which the utility operates. The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

**Consolidation.** The accompanying financial statements are presented on a consolidated basis and include the accounts of Southwest Gas Corporation and all subsidiaries, except for Southwest Gas Capital II (see Note 5). All significant intercompany balances and transactions have been eliminated with the exception of transactions between Southwest and NPL in accordance with Statement of Financial Accounting Standards ("SFAS") No. 71, "Accounting for the Effects of Certain Types of Regulation."

**Net Utility Plant.** Net utility plant includes gas plant at original cost, less the accumulated provision for depreciation and amortization, plus the unamortized balance of acquisition adjustments. Original cost includes contracted services, material, payroll and related costs such as taxes and benefits, general and administrative expenses, and an allowance for funds used during construction, less contributions in aid of construction.

**Deferred Purchased Gas Costs.** The various regulatory commissions have established procedures to enable Southwest to adjust its billing rates for changes in the cost of natural gas purchased. The difference between the current cost of gas purchased and the cost of gas recovered in billed rates is deferred. Generally, these deferred amounts are recovered or refunded within one year.

**Income Taxes.** The Company uses the asset and liability method of accounting for income taxes. Under the asset and liability method, deferred tax assets and liabilities are

recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in the period that includes the enactment date.

For regulatory and financial reporting purposes, investment tax credits ("ITC") related to gas utility operations are deferred and amortized over the life of related fixed assets.

**Cash and Cash Equivalents.** For purposes of reporting consolidated cash flows, cash and cash equivalents include cash on hand and financial instruments with a purchased maturity of three months or less.

**Accumulated Removal Costs.** In accordance with approved regulatory practices, the depreciation expense for Southwest includes a component to recover removal costs associated with utility plant retirements. In accordance with the Securities and Exchange Commission's ("SEC") position on presentation of these amounts, management has reclassified \$125 million and \$105 million, as of December 31, 2006 and 2005, respectively, of estimated removal costs from accumulated depreciation to accumulated removal costs within the liabilities section of the balance sheet.

**Gas Operating Revenues.** Revenues are recorded when customers are billed. Customer billings are based on monthly meter reads and are calculated in accordance with applicable tariffs and state and local laws, regulations, and agreements. An estimate of the amount of natural gas distributed, but not yet billed, to residential and commercial customers from the latest meter reading date to the end of the reporting period is also recognized as accrued utility revenue.

The Company acts as an agent for state and local taxing authorities in the collection and remission of a variety of taxes, including franchise fees, sales and use taxes, and surcharges. These taxes are not included in gas operating revenues, except for certain franchise fees in California operating jurisdictions which are not significant.

**Construction Revenues.** The majority of the NPL contracts are performed under unit price contracts. Generally, these contracts state prices per unit of installation. Typical installations are accomplished in two weeks or less. Revenues are recorded as installations are completed. Long-term fixed-price contracts use the percentage-of-completion method of accounting and, therefore, take into account the cost, estimated earnings, and revenue to date on contracts not yet completed. The amount of revenue recognized is based on costs expended to date relative to anticipated final contract costs. Revisions in estimates of costs and earnings during the course of the work are reflected in the accounting period in which the facts requiring revision become known. If a loss on a contract becomes known or is anticipated, the entire amount of the estimated ultimate loss is recognized at that time in the financial statements.

**Depreciation and Amortization.** Utility plant depreciation is computed on the straight-line remaining life method at composite rates considered sufficient to amortize costs over estimated service lives, including components which compensate for salvage value, removal costs, and retirements, as approved by the appropriate regulatory agency. When plant is retired from service, the original cost of plant, including cost of removal, less salvage, is charged to the accumulated provision for depreciation. Costs related to refunding utility debt and debt issuance expenses are deferred and amortized over the weighted-average lives of the new issues. Other regulatory assets, including acquisition adjustments, are amortized when appropriate, over time periods authorized by regulators. Nonutility and construction services-related property and equipment are depreciated on a straight-line method based on the estimated useful lives of the related assets.

**Allowance for Funds Used During Construction ("AFUDC").** AFUDC represents the cost of both debt and equity funds used to finance utility construction. AFUDC is capitalized as part of the cost of utility plant. The Company capitalized \$2.8 million in 2006, \$2 million in 2005, and \$808,000 in 2004 of AFUDC related to natural gas utility operations. The debt portion of AFUDC is reported in the consolidated statements of income as an offset to net interest deductions and the equity portion is reported as other income. The debt portion of AFUDC was \$1.4 million, \$1.1 million and \$691,000 for 2006, 2005 and 2004, respectively. Utility plant construction costs, including AFUDC, are recovered in authorized rates through depreciation when completed projects are placed into operation, and general rate relief is requested and granted.

**Earnings Per Share.** Basic earnings per share ("EPS") are calculated by dividing net income by the weighted-average number of shares outstanding during the period. Diluted EPS includes the effect of additional weighted-average common stock equivalents (stock options and performance shares). Unless otherwise noted, the term "Earnings Per Share" refers to Basic EPS. A reconciliation of the shares used in the Basic and Diluted EPS calculations is shown in the following table. Net income was the same for Basic and Diluted EPS calculations.

	2006	2005	2004
(In thousands)			
Average basic shares	40,566	38,132	35,204
Effect of dilutive securities:			
Stock options	195	146	111
Performance shares	214	189	173
Average diluted shares	<u>40,975</u>	<u>38,467</u>	<u>35,488</u>

**Derivatives.** In managing its gas supply portfolios, Southwest uses fixed-price and variable-rate arrangements which qualify as derivative instruments as defined under SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended (SFAS No. 133). However, such contracts qualify for the normal purchases and normal sales exception under SFAS No. 133 or have no significant market

value. The Company does not currently utilize other stand-alone derivative financial instruments for speculative purposes or for hedging.

**Recently Issued Accounting Pronouncements.** In February 2006, the Financial Accounting Standards Board ("FASB") issued SFAS No. 155, "Accounting for Certain Hybrid Financial Instruments—an amendment of FASB Statements No. 133 and 140." SFAS No. 155 permits fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation and clarifies several other related issues. The provisions of SFAS No. 155 are effective for the Company for all financial instruments acquired or issued after January 1, 2007. The adoption of the standard is not expected to have a material impact on the financial position or results of operations of the Company.

In March 2006, the FASB issued SFAS No. 156, "Accounting for Servicing of Financial Assets—an amendment of FASB Statement No. 140." SFAS No. 156 addresses the recognition and measurement of separately recognized servicing assets and liabilities and provides an approach to simplify efforts to obtain hedge-like (offset) accounting. The provisions of SFAS No. 156 are effective for the Company for the recognition and initial measurement of servicing assets and liabilities acquired or issued after January 1, 2007. The adoption of the standard is not expected to have a material impact on the financial position or results of operations of the Company.

In June 2006, the FASB issued Financial Interpretation ("FIN") No. 48, "Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109." FIN No. 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with SFAS No. 109, "Accounting for Income Taxes," and prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN No. 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN No. 48 is effective for the Company beginning January 1, 2007. The adoption of the standard is not expected to have a material impact on the financial position or results of operations of the Company.

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements." SFAS No. 157 defines fair value, establishes a framework for measuring fair value in GAAP, and expands disclosures about fair value measurements. The provisions of SFAS No. 157 are effective for the Company beginning January 1, 2008. The Company is evaluating what impact, if any, this standard might have on its financial position or results of operations.

**Stock-Based Compensation.** At December 31, 2006, the Company had two stock-based compensation plans which are described more fully in **Note 10—Stock-Based Compensation**. Prior to January 1, 2006, these plans were

Note 1 Summary of Significant Accounting Policies (Continued)

accounted for in accordance with APB Opinion No. 25, "Accounting for Stock Issued to Employees" and related interpretations. Effective January 1, 2006, the Company adopted SFAS No. 123 (revised 2004) "Share-Based Payment", using the modified prospective transition method. Accordingly, financial information for prior periods has not been restated. The adoption of SFAS No. 123 (revised 2004) did not have a material impact on the Company's financial position, results of operations, or cash flows. Under the modified prospective transition method, expense is recognized for any new awards

granted after the effective date and for the unvested portion of awards granted prior to the effective date. Total stock-based compensation expense recognized in the consolidated statements of income for the year ended December 31, 2006 was \$3.3 million (net of related tax benefits of \$1.6 million). The pro forma effects of recognizing the estimated fair value of stock-based compensation for periods prior to the adoption of SFAS No. 123 (revised 2004) are presented below (thousands of dollars, except per share amounts):

	2005	2004
Net income, as reported	\$43,823	\$56,775
Add: Stock-based employee compensation expense included in reported net income, net of related tax benefits	2,469	1,825
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax benefits	(2,620)	(1,958)
Pro forma net income	<u>\$43,672</u>	<u>\$56,642</u>
Earnings per share:		
Basic—as reported	\$ 1.15	\$ 1.61
Basic—pro forma	1.15	1.61
Diluted—as reported	1.14	1.60
Diluted—pro forma	1.14	1.60

Note 2 Utility Plant

Net utility plant as of December 31, 2006 and 2005 was as follows (thousands of dollars):

December 31,	2006	2005
Gas plant:		
Storage	\$ 17,545	\$ 17,357
Transmission	243,989	239,872
Distribution	3,153,399	2,917,959
General	219,527	213,906
Other	128,850	127,493
	<u>3,763,310</u>	<u>3,516,587</u>
Less: accumulated depreciation	(1,175,600)	(1,083,900)
Acquisition adjustments, net	1,992	2,173
Construction work in progress	78,402	54,287
Net utility plant	<u>\$ 2,668,104</u>	<u>\$ 2,489,147</u>

Depreciation and amortization expense on gas plant was \$145 million in 2006, \$137 million in 2005, and \$128 million in 2004.

## Note 2 Utility Plant (Continued)

**Operating Leases and Rentals.** Southwest leases a portion of its corporate headquarters office complex in Las Vegas, and its administrative offices in Phoenix. The leases provide for current terms which expire in 2017 and 2009, respectively, with optional renewal terms available at the expiration dates. The rental payments for the corporate headquarters office complex are \$2 million in each of the years 2007 through 2011 and \$12.2 million cumulatively thereafter. The rental payments for the Phoenix administrative offices are \$1.5 million for each of the years 2007 and 2008, and \$1 million in 2009 when the lease expires. In addition to the above, the Company leases certain office and construction equipment. The majority of these leases are short-term. These leases are accounted for as operating leases, and for the gas segment are treated as such for regulatory purposes. Rentals included in operating expenses for all operating leases were \$19.2 million in 2006, \$19 million in 2005, and \$20.3 million in 2004. These amounts include NPL lease expenses of

approximately \$11.5 million in 2006, \$11.5 million in 2005, and \$9.8 million in 2004 for various short-term operating leases of equipment and temporary office sites.

The following is a schedule of future minimum lease payments for significant non-cancelable operating leases (with initial or remaining terms in excess of one year) as of December 31, 2006 (thousands of dollars):

<u>Year Ending December 31,</u>	
2007	\$ 5,378
2008	4,868
2009	4,010
2010	2,568
2011	2,433
Thereafter	<u>12,890</u>
Total minimum lease payments	<u>\$32,147</u>

## Note 3 Receivables and Related Allowances

**B**usiness activity with respect to gas utility operations is conducted with customers located within the three-state region of Arizona, Nevada, and California. At December 31, 2006, the gas utility customer accounts receivable balance was \$182 million. Approximately 54 percent of the gas utility customers were in Arizona, 36 percent in Nevada, and 10 percent in California. Although the Company seeks to minimize its credit risk related to utility operations by requiring security deposits from new customers, imposing late fees, and actively pursuing collection on overdue accounts, some accounts are ultimately not collected. Provisions for uncollectible accounts are recorded monthly, as needed, and are included in the ratemaking process as a cost of service. Activity in the allowance for uncollectibles is summarized as follows (thousands of dollars):

	<u>Allowance for Uncollectibles</u>
Balance, December 31, 2003	\$ 2,246
Additions charged to expense	2,586
Accounts written off, less recoveries	<u>(2,860)</u>
Balance, December 31, 2004	1,972
Additions charged to expense	3,787
Accounts written off, less recoveries	<u>(3,458)</u>
Balance, December 31, 2005	2,301
Additions charged to expense	5,805
Accounts written off, less recoveries	<u>(5,085)</u>
Balance, December 31, 2006	<u>\$ 3,021</u>

## Note 4 Regulatory Assets and Liabilities

**N**atural gas operations are subject to the regulation of the Arizona Corporation Commission ("ACC"), the Public Utilities Commission of Nevada ("PUCN"), the California Public Utilities Commission ("CPUC"), and the Federal Energy Regulatory Commission ("FERC"). Southwest accounting policies conform to generally accepted accounting principles applicable to rate-regulated enterprises, principally SFAS No. 71, and reflect the effects of the ratemaking process. SFAS

No. 71 allows for the deferral as regulatory assets, costs that otherwise would be expensed if it is probable future recovery from customers will occur. If rate recovery is no longer probable, due to competition or the actions of regulators, Southwest is required to write-off the related regulatory asset. Regulatory liabilities are recorded if it is probable that revenues will be reduced for amounts that will be credited to customers through the ratemaking process.

#### Note 4 Regulatory Assets and Liabilities (Continued)

The following table represents existing regulatory assets and liabilities (thousands of dollars):

December 31,	2006	2005
<b>Regulatory assets:</b>		
Accrued pension and other postretirement benefit costs * (Note 9)	\$ 101,402	\$ —
Deferred purchased gas costs	77,007	109,415
Accrued purchased gas costs **	40,500	75,300
SFAS No. 109— income taxes, net *	1,846	2,447
Unamortized premium on reacquired debt *	17,676	18,386
Other	30,099	28,236
	<u>268,530</u>	<u>233,784</u>
<b>Regulatory liabilities:</b>		
Accumulated removal costs	(125,000)	(105,000)
Other ***	(1,111)	(821)
<b>Net regulatory assets (liabilities)</b>	<u><u>\$ 142,419</u></u>	<u><u>\$ 127,963</u></u>

\* Included in Deferred charges and other assets on the Consolidated Balance Sheet.

\*\* Included in Prepaids and other current assets on the Consolidated Balance Sheet.

\*\*\* Included in Other deferred credits on the Consolidated Balance Sheet.

Other regulatory assets include deferred costs associated with rate cases, regulatory studies, margin and interest-tracking accounts, and state mandated public purpose

programs (including low income and conservation programs), as well as amounts associated with accrued absence time and deferred post-retirement benefits other than pensions.

#### Note 5 Preferred Trust Securities and Subordinated Debentures

In June 2003, the Company created Southwest Gas Capital II ("Trust II"), a wholly owned subsidiary, as a financing trust for the sole purpose of issuing preferred trust securities for the benefit of the Company. In August 2003, Trust II publicly issued \$100 million of 7.70% Preferred Trust Securities ("Preferred Trust Securities"). In connection with the Trust II issuance of the Preferred Trust Securities and the related purchase by the Company for \$3.1 million of all of the Trust II common securities ("Common Securities"), the Company issued \$103.1 million principal amount of its 7.70% Junior Subordinated Debentures, due 2043 ("Subordinated Debentures") to Trust II. The sole assets of Trust II are and will be the Subordinated Debentures. The interest and other payment dates on the Subordinated Debentures correspond to the distribution and other payment dates on the Preferred Trust Securities and Common Securities. Under certain circumstances, the Subordinated Debentures may be distributed to the holders of the Preferred Trust Securities and holders of the Common Securities in liquidation of Trust II. The Subordinated Debentures are redeemable at the option of the Company after August 2008 at a redemption price of \$25 per Subordinated Debenture plus accrued and unpaid interest.

In the event that the Subordinated Debentures are repaid, the Preferred Trust Securities and the Common Securities will be redeemed on a pro rata basis at \$25 (par value) per Preferred Trust Security and Common Security plus accumulated and unpaid distributions. Company obligations under the Subordinated Debentures, the Trust Agreement (the agreement under which Trust II was formed), the guarantee of payment of certain distributions, redemption payments and liquidation payments with respect to the Preferred Trust Securities to the extent Trust II has funds available therefore and the indenture governing the Subordinated Debentures, including the Company agreement pursuant to such indenture to pay all fees and expenses of Trust II, other than with respect to the Preferred Trust Securities and Common Securities, taken together, constitute a full and unconditional guarantee on a subordinated basis by the Company of payments due on the Preferred Trust Securities. As of December 31, 2006, 4.1 million Preferred Trust Securities were outstanding.

The Company has the right to defer payments of interest on the Subordinated Debentures by extending the interest payment period at any time for up to 20 consecutive quarters

(each, an "Extension Period"). If interest payments are so deferred, distributions to Preferred Trust Securities holders will also be deferred. During such Extension Period, distributions will continue to accrue with interest thereon (to the extent permitted by applicable law) at an annual rate of 7.70% per annum compounded quarterly. There could be multiple Extension Periods of varying lengths throughout the term of the Subordinated Debentures. If the Company exercises the right to extend an interest payment period, the Company shall not during such Extension Period (i) declare or pay dividends on, or make a distribution with respect to, or redeem, purchase or acquire or make a liquidation payment with respect to, any of its capital stock, or (ii) make any payment of interest, principal, or premium, if any, on or repay, repurchase, or redeem any debt securities issued by the Company that rank equal with or junior to the Subordinated Debentures; provided, however, that restriction (i) above does not apply to any stock dividends paid by the Company where

the dividend stock is the same as that on which the dividend is being paid. The Company has no present intention of exercising its right to extend the interest payment period on the Subordinated Debentures.

Although the Company owns 100 percent of the common voting securities of Trust II, under Interpretation No. 46 "Consolidation of Variable Interest Entities—an Interpretation of ARB No. 51", the Company is not considered the primary beneficiary of this trust and therefore Trust II is not consolidated. As a result, the \$103.1 million Subordinated Debentures are shown on the balance sheet of the Company, net of the \$3.1 million Common Securities, as Subordinated debentures due to Southwest Gas Capital II. Payments and amortizations associated with the Subordinated Debentures are classified on the consolidated statements of income as Net interest deductions on subordinated debentures.



December 31,

2006

2005

Carrying  
AmountMarket  
ValueCarrying  
AmountMarket  
Value

(Thousands of dollars)

## Debentures:

7 1/2% Series, due 2006

\$ — \$ — \$ 75,000 \$ 76,155

Notes, 8.375%, due 2011

200,000 221,200 200,000 225,720

Notes, 7.625%, due 2012

200,000 217,600 200,000 222,040

8% Series, due 2026

75,000 88,748 75,000 90,525

Medium-term notes, 6.89% series, due 2007

17,500 17,654 17,500 17,971

Medium-term notes, 6.27% series, due 2008

25,000 25,263 25,000 25,600

Medium-term notes, 7.59% series, due 2017

25,000 28,155 25,000 28,573

Medium-term notes, 7.78% series, due 2022

25,000 28,645 25,000 29,088

Medium-term notes, 7.92% series, due 2027

25,000 29,398 25,000 30,000

Medium-term notes, 6.76% series, due 2027

7,500 7,832 7,500 7,976

Unamortized discount

(4,021) — (4,657) —

595,979 670,343

## Revolving credit facility and commercial paper

147,000 147,000 150,000 150,000

## Industrial development revenue bonds:

## Variable-rate bonds:

Tax-exempt Series A, due 2028

50,000 50,000 50,000 50,000

2003 Series A, due 2038

50,000 50,000 50,000 50,000

2003 Series B, due 2038

50,000 50,000 50,000 50,000

## Fixed-rate bonds:

6.10% 1999 Series A, due 2038

12,410 13,093 12,410 13,068

5.95% 1999 Series C, due 2038

14,320 15,136 14,320 15,057

5.55% 1999 Series D, due 2038

8,270 8,696 8,270 8,593

5.45% 2003 Series C, due 2038

30,000 30,705 30,000 30,264

5.25% 2003 Series D, due 2038

20,000 20,836 20,000 20,400

5.80% 2003 Series E, due 2038

15,000 15,629 15,000 15,218

5.25% 2004 Series A, due 2034

65,000 67,210 65,000 65,878

5.00% 2004 Series B, due 2033

75,000 76,688 75,000 75,000

4.85% 2005 Series A, due 2035 net of \$24.6 million held in trust in 2005

100,000 101,050 75,366 73,030

4.75% 2006 Series A, due 2036

56,000 56,213 — —

Unamortized discount

(4,697) — (4,159) —

541,303 461,207

## Other

29,617 — 26,563 —

1,313,899 1,308,113

## Less: current maturities

(27,545) (83,215)

## Long-term debt, less current maturities

\$1,286,354 \$1,224,898

## Note 6 Long-Term Debt (Continued)

In April 2006, the Company amended its \$300 million credit facility. The facility was originally scheduled to expire in April 2010 and was extended to April 2011. The Company will continue to use \$150 million of the \$300 million as long-term debt and the remaining \$150 million for working capital purposes. Interest rates for the facility are calculated at either the London Interbank Offering Rate plus an applicable margin, or the greater of the prime rate or one-half of one percent plus the Federal Funds rate. The applicable margin, unused commitment fee, and utilization fee associated with the amended credit facility are lower than those of the previous facility. At December 31, 2006, no borrowings were outstanding on the short-term portion of the credit facility and \$147 million was outstanding on the long-term portion.

In September 2006, the Company issued \$56 million in Clark County, Nevada 4.75% industrial development revenue bonds ("IDRBs") Series 2006A pursuant to a financing agreement and indenture. The IDRBs were issued at a discount of 0.625% and are due September 1, 2036. The proceeds from the IDRBs were used by Southwest to expand and upgrade facilities in Clark County, Nevada.

The Company's Revolving Credit Facility, letters of credit, and certain bond insurance policies contain financial covenants, the most restrictive of which require a maximum leverage ratio of 70 percent (debt to capitalization as defined) and a minimum net worth calculation of \$475 million adjusted for equity issuances after May 10, 2002. If the Company was not in compliance with these covenants, an event of default would

occur, which if not cured could cause the amounts outstanding to become due and payable. This would also trigger cross-default provisions in substantially all other outstanding indebtedness of the Company. At December 31, 2006, the Company was in compliance with the applicable covenants.

The effective interest rates on the 2003 Series A and B variable-rate IDRBs were 5.14 percent and 4.09 percent, respectively, at December 31, 2006 and 4.64 percent and 3.84 percent, respectively, at December 31, 2005. The effective interest rates on the tax-exempt Series A variable-rate IDRBs were 5.03 percent and 4.55 percent at December 31, 2006 and 2005, respectively.

The fair value of the revolving credit facility and the variable-rate IDRBs approximates carrying value. Market values for the debentures and fixed-rate IDRBs were determined based on dealer quotes using trading records for December 31, 2006 and 2005, as applicable, and other secondary sources which are customarily consulted for data of this kind.

Estimated maturities of long-term debt for the next five years are \$27.5 million, \$34.1 million, \$6.6 million, \$1.4 million, and \$347 million, respectively.

The \$7.5 million medium-term notes, 6.76% series, due 2027 contain a put feature at the discretion of the bondholder on one date only in 2007. If the bondholder does not exercise the put on that date, the notes mature in 2027. If the bondholder exercises the put, the maturities of long-term debt for 2007 will total \$35 million.

## Note 7 Short-Term Debt

As discussed in Note 6, Southwest has a \$300 million five-year credit facility, effective April 2006, of which \$150 million has been designated by management for working capital purposes (and related outstanding amounts are designated as short-term debt). No short-term borrowings were

outstanding on the credit facility at December 31, 2006. Short-term borrowings on the credit facility were \$24 million at December 31, 2005. The weighted-average interest rate on these borrowings was 5.08 percent at December 31, 2005.

## Note 8 Commitments and Contingencies

**L**egal and Regulatory Proceedings. The Company maintains liability insurance for various risks associated with the operation of its natural gas pipelines and facilities. In May 2005, a leaking natural gas line was involved in a fire that severely injured an individual. By December 2005, the Company had recorded a total liability related to this incident equal to the Company's maximum self-insured retention level for the policy year August 2004 to July 2005 of \$11 million. In the fourth quarter of 2006, the case was settled. The amount of the settlement that exceeded \$11 million was covered by insurance. The Company's current insurance contracts limit

the self-insured retention to \$1 million per incident plus payment of the first \$5 million in aggregate claims above \$1 million.

The Company is a defendant in miscellaneous legal proceedings. The Company is also a party to various regulatory proceedings. The ultimate dispositions of these proceedings are not presently determinable; however, it is the opinion of management that no litigation or regulatory proceeding to which the Company is subject will have a material adverse impact on its financial position or results of operations.

Southwest has a noncontributory qualified retirement plan with defined benefits covering substantially all employees and a separate unfunded supplemental retirement plan ("SERP") which is limited to officers. Southwest also provides postretirement benefits other than pensions ("PBOP") to its qualified retirees for health care, dental, and life insurance benefits.

In September 2006, the FASB issued SFAS No. 158, which requires employers to recognize the overfunded or underfunded positions of defined benefit postretirement plans, including pension plans, in their balance sheets. Under SFAS No. 158, any actuarial gains and losses, prior service costs and transition assets or obligations that were not recognized under previous accounting standards must be recognized in accumulated other comprehensive income under stockholders' equity, net of tax, until they are amortized as a component of

net periodic benefit cost. SFAS No. 158 does not change how net periodic pension and postretirement costs are accounted for and reported in the income statement. The Company adopted the provisions of SFAS No. 158 effective December 31, 2006.

In accordance with SFAS No. 71, the Company has established a regulatory asset for the portion of the total amounts otherwise chargeable to accumulated other comprehensive income that are expected to be recovered through rates in future periods. The changes in actuarial gains and losses, prior service costs and transition assets or obligations pertaining to the regulatory asset will be recognized as an adjustment to the regulatory asset account as these amounts are recognized as components of net periodic pension costs each year. The following table discloses the incremental effect of applying the provisions of SFAS No. 158 (and SFAS No. 71) to individual line items in the balance sheet as of December 31, 2006.

	Before Application of SFAS No. 158 *	SFAS No. 158 Adjustments	SFAS No. 71 Regulatory Adjustments	Adjusted Balance **
(Thousands of dollars)				
<b>Assets</b>				
Deferred charges and other assets	\$ 101,712	\$ —	\$77,283	\$ 178,995
Total assets	3,407,682	—	77,283	3,484,965
<b>Capitalization and Liabilities</b>				
Accumulated other comprehensive income (loss), net	(8,598)	(52,983)	47,915	(13,666)
Total equity	906,493	(52,983)	47,915	901,425
Total capitalization	2,292,847	(52,983)	47,915	2,287,779
Current liabilities:				
Deferred income taxes	16,383	(912)	—	15,471
Other current liabilities	53,501	2,400	—	55,901
Total current liabilities	494,576	1,488	—	496,064
Deferred income taxes and other credits:				
Deferred income taxes and investment tax credits	310,686	(31,561)	29,368	308,493
Other deferred credits	178,622	83,056	—	261,678
Total deferred income taxes and other credits	620,259	51,495	29,368	701,122
Total capitalization and liabilities	\$3,407,682	\$ —	\$77,283	\$3,484,965

\* Balances before application of SFAS No. 158 include the effects of 2006 plan experience and changes in actuarial assumptions on the additional minimum liability, coupled with the regulatory impacts of SFAS No. 71.

\*\* At December 31, 2006, the combined net funded status of the three plans reflected a liability of \$155 million. Of this amount, approximately \$101 million was offset with a regulatory asset.

The table below discloses net amounts recognized in accumulated other comprehensive income as a result of adopting the provisions of SFAS No. 158 (as impacted by SFAS No. 71) as of December 31, 2006. Tax amounts are calculated using a 38 percent rate.

	Total	Qualified Retirement Plan	SERP	PBOP
(Thousands of dollars)				
Adjustments to adopt SFAS No. 158:				
Net actuarial loss, net of \$44.9 million of tax	\$(73,323)	\$(62,464)	\$(8,045)	\$(2,814)
Net transition obligation, net of \$2 million of tax	(3,225)	—	—	(3,225)
Prior service credit, net of \$9,000 of tax	14	14	—	—
Reversal of additional minimum pension liability, net of \$14.4 million of tax	23,551	16,432	7,119	—
Estimated amounts recoverable through rates, net of \$29.4 million of tax	47,915	41,876	—	6,039
Total amounts recognized in accumulated other comprehensive income	<u>\$ (5,068)</u>	<u>\$ (4,142)</u>	<u>\$ (926)</u>	<u>\$ —</u>

Investment objectives and strategies for the qualified retirement plan are developed and approved by the Pension Plan Investment Committee of the Board of Directors of the Company. They are designed to preserve capital, maintain minimum liquidity required for retirement plan operations and effectively manage pension assets.

A target portfolio of investments in the qualified retirement plan is developed by the Pension Plan Investment Committee and is reevaluated periodically. Rate of return assumptions are determined by evaluating performance expectations of the target portfolio. Projected benefit obligations are estimated using actuarial assumptions and Company benefit policy. A target mix of assets is then determined based on acceptable risk versus estimated returns in order to fund the benefit obligation. The current percentage ranges of the target portfolio are:

Type of Investment	Percentage Range
Equity securities	58 to 70
Debt securities	32 to 38
Other	up to 5

The Company's pension costs for these plans are affected by the amount of cash contributions to the plans, the return on plan assets, discount rates, and by employee demographics, including age, compensation, and length of service. Changes made to the provisions of the plans may also impact current and future pension costs. Actuarial formulas are used in the determination of pension costs and are affected by actual plan experience and assumptions about future experience. Key

actuarial assumptions include the expected return on plan assets, the discount rate used in determining the projected benefit obligation and pension costs, and the assumed rate of increase in employee compensation. Relatively small changes in these assumptions, particularly the discount rate, may significantly affect pension costs and plan obligations for the qualified retirement plan.

SFAS No. 87 *Employer's Accounting for Pensions* states that the assumed discount rate should reflect the rate at which the pension benefits could be effectively settled. In making this estimate, in addition to rates implicit in current prices of annuity contracts that could be used to settle the liabilities, employers may look to rates of return on high-quality fixed-income investments currently available and expected to be available during the period to maturity of the pension benefits. In determining the discount rate, the Company matches the plan's projected cash flows to a spot-rate yield curve based on highly rated corporate bonds. The resulting rate is then rounded to the nearest 25 basis points.

Due to an increase in market interest rates for high-quality fixed-income investments, the Company raised the discount rate to 6.00% at December 31, 2006 from 5.75% at December 31, 2005. The weighted-average rate of compensation increase was raised to 3.75% from 3.30%. The Company maintained its asset return assumption for 2007 at 8.50%. These offsetting changes will not result in a significant change in pension expense for 2007.

Note 9 Pension and Other Postretirement Benefits (Continued)

The following tables set forth the retirement plan, SERP, and PBOP funded status and amounts recognized on the Consolidated Balance Sheets and Statements of Income.

	2006		
	Qualified Retirement Plan	SERP	PBOP
(Thousands of dollars)			
<b>Change in benefit obligations</b>			
Benefit obligation for service rendered to date at beginning of year (PBO/PBO/APBO)	\$ 473,418	\$ 34,123	\$ 37,553
Service cost	16,284	211	854
Interest cost	26,805	1,893	2,118
Actuarial loss (gain)	(4,806)	(207)	(297)
Benefits paid	(15,898)	(2,363)	(1,121)
Benefit obligation at end of year (PBO/PBO/APBO)	<u>495,803</u>	<u>33,657</u>	<u>39,107</u>
<b>Change in plan assets</b>			
Market value of plan assets at beginning of year	338,618	—	20,979
Actual return on plan assets	42,733	—	2,742
Employer contributions	23,253	2,363	1,107
Benefits paid	(15,898)	(2,363)	—
Market value of plan assets at end of year	<u>388,706</u>	<u>—</u>	<u>24,828</u>
Funded status at year end	<u><u>\$(107,097)</u></u>	<u><u>\$(33,657)</u></u>	<u><u>\$(14,279)</u></u>
<b>Weighted-average assumptions (benefit obligation)</b>			
Discount rate	6.00%	6.00%	6.00%
Weighted-average rate of compensation increase	3.75%	3.75%	3.75%
<b>Asset Allocation</b>			
Equity securities	63%		77%
Debt securities	32%		16%
Other	5%		7%
Total	<u>100%</u>	<u>N/A</u>	<u>100%</u>

Note 9 Pension and Other Postretirement Benefits (Continued)

	2005		
	Qualified Retirement Plan	SERP	PBOP
(Thousands of dollars)			
<b>Change in benefit obligations</b>			
Benefit obligation for service rendered to date at beginning of year (PBO/PBO/APBO)	\$ 428,116	\$ 31,385	\$ 35,988
Service cost	15,787	223	837
Interest cost	25,327	1,811	2,115
Actuarial loss (gain)	17,842	2,963	103
Benefits paid	(13,654)	(2,259)	(1,490)
Benefit obligation at end of year (PBO/PBO/APBO)	<u>473,418</u>	<u>34,123</u>	<u>37,553</u>
<b>Change in plan assets</b>			
Market value of plan assets at beginning of year	318,664	—	18,750
Actual return on plan assets	15,988	—	1,102
Employer contributions	17,620	2,259	1,127
Benefits paid	(13,654)	(2,259)	—
Market value of plan assets at end of year	<u>338,618</u>	<u>—</u>	<u>20,979</u>
Funded status	(134,800)	(34,123)	(16,574)
Unrecognized net actuarial loss (gain)	123,028	14,428	5,954
Unrecognized transition obligation (2012)	—	—	6,069
Unrecognized prior service cost	(34)	9	—
Prepaid (accrued) benefit cost	<u>\$ (11,806)</u>	<u>\$(19,686)</u>	<u>\$ (4,551)</u>
Accrued benefit liability	<u>\$ (66,082)</u>	<u>\$(32,580)</u>	<u>\$ (4,551)</u>
Additional minimum pension liability adjustment	<u>54,276</u>	<u>12,894</u>	<u>—</u>
	<u>\$ (11,806)</u>	<u>\$(19,686)</u>	<u>\$ (4,551)</u>
<b>Weighted-average assumptions (benefit obligation)</b>			
Discount rate	5.75%	5.75%	5.75%
Weighted-average rate of compensation increase	3.30%	3.30%	3.30%
<b>Asset Allocation</b>			
Equity securities	61%		71%
Debt securities	30%		15%
Other	9%		14%
Total	<u>100%</u>	<u>N/A</u>	<u>100%</u>

Estimated funding for the plans above during calendar year 2007 is approximately \$24 million. The accumulated benefit obligation for the retirement plan was \$422 million and \$405 million, and for the SERP was \$32.2 million and \$32.6 million at December 31, 2006 and 2005, respectively.

Pension benefits expected to be paid for each of the next five years beginning with 2007 are the following: \$16.8 million, \$18 million, \$19.2 million, \$20.6 million, and \$22.2 million. Pension benefits expected to be paid during 2012 to 2016 total \$138 million. Retiree welfare benefits expected to be paid for each of the next five years beginning with 2007 are the following: \$1.4 million, \$1.5 million, \$1.6 million, \$1.7 million, and \$1.8 million. Retiree welfare benefits expected to be paid during 2012 to 2016 total \$10.5 million. SERP benefits

expected to be paid for each of the next five years beginning with 2007 are the following: \$2.4 million, \$2.5 million, \$2.5 million, \$2.5 million, and \$2.5 million. SERP benefits expected to be paid during 2012 to 2016 total \$12.6 million. No assurance can be made that actual funding and benefits paid will match our estimates.

For PBOP measurement purposes, the per capita cost of covered health care benefits is assumed to increase five percent annually. The Company makes fixed contributions for health care benefits of employees who retire after 1988, but pays up to 100 percent of covered health care costs for employees who retired prior to 1989. The assumed annual rate of increase noted above applies to the benefit obligations of pre-1989 retirees only.

**Components of net periodic benefit cost:**

	Qualified Retirement Plan			SERP			PBOP		
	2006	2005	2004	2006	2005	2004	2006	2005	2004
(Thousands of dollars)									
Service cost	\$ 16,284	\$ 15,787	\$ 13,790	\$ 211	\$ 223	\$ 211	\$ 854	\$ 837	\$ 722
Interest cost	26,805	25,327	23,659	1,893	1,811	1,745	2,118	2,115	2,180
Expected return on plan assets	(30,608)	(29,553)	(28,067)	—	—	—	(1,817)	(1,675)	(1,426)
Amortization of prior service costs (credits)	(11)	(11)	54	9	116	140	—	—	—
Amortization of transition obligation	—	—	—	—	—	—	867	867	867
Amortization of net loss	5,352	2,453	—	1,244	912	639	168	136	213
Net periodic benefit cost	<u>\$ 17,822</u>	<u>\$ 14,003</u>	<u>\$ 9,436</u>	<u>\$ 3,357</u>	<u>\$ 3,062</u>	<u>\$ 2,735</u>	<u>\$ 2,190</u>	<u>\$ 2,280</u>	<u>\$ 2,556</u>
<b>Weighted-average assumptions (net benefit cost)</b>									
Discount rate	5.75%	6.00%	6.50%	5.75%	6.00%	6.50%	5.75%	6.00%	6.50%
Expected return on plan assets	8.50%	8.75%	8.75%	8.50%	8.75%	8.75%	8.50%	8.75%	8.75%
Weighted-average rate of compensation increase	3.30%	4.00%	4.25%	3.30%	4.00%	4.25%	3.30%	4.00%	4.25%

The estimated net loss that will be amortized from accumulated other comprehensive income or regulatory assets into net periodic benefit cost over the next year is \$5 million for the qualified retirement plan and \$1.1 million for the SERP. The estimated transition obligation for the PBOP that will be amortized from regulatory assets into net periodic benefit cost over the next year is \$870,000. The estimated prior service costs (credits) for the qualified retirement plan and SERP and the estimated net loss for the PBOP that will be amortized over the next year are not significant.

The Employees' Investment Plan provides for purchases of various mutual fund investments and Company common stock by eligible Southwest employees through deductions of a percentage of base compensation, subject to IRS limitations. Southwest matches up to one-half of amounts deferred. The maximum matching contribution is three percent of an employee's annual compensation. The cost of the plan was

\$3.6 million in 2006, \$3.5 million in 2005, and \$3.5 million in 2004. NPL has a separate plan, the cost and liability for which are not significant.

Southwest has a deferred compensation plan for all officers and members of the Board of Directors. The plan provides the opportunity to defer up to 100 percent of annual cash compensation. Southwest matches one-half of amounts deferred by officers. The maximum matching contribution is three percent of an officer's annual base salary. Upon retirement, payments of compensation deferred, plus interest, are made in equal monthly installments over 10, 15, or 20 years, as elected by the participant. Directors have an additional option to receive such payments over a five-year period. Deferred compensation earns interest at a rate determined each January. The interest rate equals 150 percent of Moody's Seasoned Corporate Bond Rate Index.

At December 31, 2006, the Company had two stock-based compensation plans: a stock option plan and a performance share stock plan. Prior to January 1, 2006, these plans were accounted for in accordance with APB Opinion No. 25, "Accounting for Stock Issued to Employees" and related interpretations. Effective January 1, 2006, the Company adopted SFAS No. 123 (revised 2004) "Share-Based Payment", using the modified prospective transition method. Accordingly, financial information for prior periods has not been restated. The adoption of SFAS No. 123 (revised 2004) did not have a material impact on the Company's financial condition, results of operations, or cash flows. Under the modified prospective transition method, expense is recognized for any new awards granted after the effective date and for the unvested portion of awards granted prior to the effective date.

Under the option plan, the Company may grant options to purchase shares of common stock to key employees and outside directors. The option grants in 2006 consumed the remaining options that could be issued under the option plan and no future grants are anticipated. Each option has an exercise price equal to the market price of Company common stock on the date of grant and a maximum term of ten years. The options vest 40 percent at the end of year one and 30 percent at the end of years two and three. The grant date fair value of the options was estimated using the Black-Scholes option pricing model in 2006 and 2005 and the extended binomial option pricing model in 2004. The following assumptions were used in the valuation calculation:

	2006	2005	2004
Dividend yield	2.48 to 2.82%	3.14 to 3.28%	3.50%
Risk-free interest rate range	4.91 to 5.06%	3.88 to 4.09%	1.66 to 3.23%
Expected volatility range	15%	18%	13 to 20%
Expected life	6 years	6 years	1 to 3 years

The following tables summarize Company stock option plan activity and related information (thousands of options):

	2006		2005		2004	
	Number of options	Weighted-average exercise price	Number of options	Weighted-average exercise price	Number of options	Weighted-average exercise price
Outstanding at the beginning of the year	1,475	\$23.70	1,646	\$22.46	1,502	\$21.83
Granted during the year	252	32.60	347	26.00	403	23.36
Exercised during the year	(749)	23.30	(510)	21.28	(254)	20.21
Forfeited during the year	(6)	26.81	(8)	22.41	(5)	21.83
Expired during the year	(15)	28.09	—	—	—	—
Outstanding at year end	<u>957</u>	<u>\$26.26</u>	<u>1,475</u>	<u>\$23.70</u>	<u>1,646</u>	<u>\$22.46</u>
Exercisable at year end	<u>413</u>	<u>\$23.31</u>	<u>813</u>	<u>\$23.06</u>	<u>1,010</u>	<u>\$22.36</u>



The intrinsic value of a stock option is the amount by which the market value of the underlying stock exceeds the exercise price of the option. The aggregate intrinsic value of outstanding options was \$11.6 million, \$4.3 million, and \$5.3 million at December 31, 2006, December 31, 2005, and December 31, 2004, respectively. The aggregate intrinsic value of exercisable options was \$6.2 million, \$3 million, and \$3.6 million at December 31, 2006, December 31, 2005, and December 31, 2004, respectively. The aggregate intrinsic value of exercised options was \$11.3 million, \$2.6 million, and \$1.3 million during 2006, 2005, and 2004, respectively. The market value of Southwest Gas stock was \$38.37, \$26.40, and

\$25.40 at December 31, 2006, December 31, 2005, and December 31, 2004, respectively.

The weighted-average remaining contractual life for outstanding options was 7.7 years for 2006. The weighted-average remaining contractual life for exercisable options was 6.4 years for 2006. The weighted-average grant-date fair value of options granted was \$5.92 for 2006, \$4.18 for 2005, and \$1.65 for 2004. The following table summarizes information about stock options outstanding at December 31, 2006 (thousands of options):

Range of Exercise Price	Options Outstanding			Options Exercisable	
	Number outstanding	Weighted-average remaining contractual life	Weighted-average exercise price	Number exercisable	Weighted-average exercise price
\$15.00 to \$19.13	26	2.7 Years	\$18.13	26	\$18.13
\$20.49 to \$26.10	664	7.4 Years	\$24.12	368	\$23.36
\$28.75 to \$33.07	267	9.0 Years	\$32.38	19	\$29.14

As of December 31, 2006, there was \$1.5 million of total unrecognized compensation cost related to nonvested stock options. That cost is expected to be recognized over a period of 3 years. The total fair value of options vested was \$1 million, \$609,000, and \$917,000 during 2006, 2005, and 2004,

respectively. The Company received \$17.5 million in cash from the exercise of options during 2006 and a corresponding tax benefit of \$2.6 million which was recorded in additional paid-in capital. The following table summarizes the status of the Company's nonvested options as of December 31, 2006 (thousands of options):

	Number of options	Weighted-average grant date fair value
Nonvested at the beginning of the year	662	\$3.00
Granted	252	\$5.92
Vested	(364)	\$2.80
Forfeited	(6)	\$4.15
Nonvested at December 31, 2006	<u>544</u>	<u>\$4.47</u>

In addition to the option plan, the Company may issue performance shares to encourage key employees to remain in its employment to achieve short-term and long-term performance goals. Plan participants are eligible to receive a cash bonus (i.e., short-term incentive) and performance shares

(i.e., long-term incentive). The performance shares vest three years after grant (and are subject to a final adjustment as determined by the Board of Directors) and are then issued as common stock. The following table summarizes the activity of this plan (thousands of shares):

Year Ended December 31,	2006	2005	2004
Nonvested performance shares at beginning of year	357	316	381
Performance shares granted (including dividends)	95	143	156
Performance shares forfeited	—	(6)	—
Shares vested and issued*	<u>(133)</u>	<u>(96)</u>	<u>(221)</u>
Nonvested performance shares at end of year	<u>319</u>	<u>357</u>	<u>316</u>
Average grant date fair value of awards granted this year	<u>\$26.97</u>	<u>\$24.71</u>	<u>\$22.70</u>

\* Includes shares converted for taxes and retiree payouts.

# Note 11 Income Taxes

Income tax expense (benefit) consists of the following (thousands of dollars):

Year Ended December 31,	2006	2005	2004
Current:			
Federal	\$29,916	\$ 553	\$ (225)
State	4,830	2,218	(1,186)
	<u>34,746</u>	<u>2,771</u>	<u>(1,411)</u>
Deferred:			
Federal	9,385	21,301	28,607
State	366	540	3,041
	<u>9,751</u>	<u>21,841</u>	<u>31,648</u>
Total income tax expense	<u>\$44,497</u>	<u>\$24,612</u>	<u>\$30,237</u>

Deferred income tax expense (benefit) consists of the following significant components (thousands of dollars):

Year Ended December 31,	2006	2005	2004
Deferred federal and state:			
Property-related items	\$ 28,372	\$ (3,143)	\$ (3,165)
Purchased gas cost adjustments	(22,188)	28,094	34,923
Employee benefits	(3,223)	2,232	240
Injuries and damages reserves	4,543	(4,072)	190
All other deferred	<u>3,115</u>	<u>(402)</u>	<u>328</u>
Total deferred federal and state	10,619	22,709	32,516
Deferred ITC, net	<u>(868)</u>	<u>(868)</u>	<u>(868)</u>
Total deferred income tax expense	<u>\$ 9,751</u>	<u>\$21,841</u>	<u>\$31,648</u>

The consolidated effective income tax rate for the period ended December 31, 2006 and the two prior periods differ from the federal statutory income tax rate. The sources of these differences and the effect of each are summarized as follows:

Year Ended December 31,	2006	2005	2004
Federal statutory income tax rate	35.0%	35.0%	35.0%
Net state taxes	2.5	2.7	2.8
Property-related items	0.6	1.1	0.8
Effect of closed tax years and resolved issues	(1.3)	—	(1.8)
Tax credits	(0.7)	(1.3)	(1.0)
Corporate owned life insurance	(0.9)	(1.6)	(0.7)
All other differences	<u>(0.5)</u>	<u>0.1</u>	<u>(0.3)</u>
Consolidated effective income tax rate	<u>34.7%</u>	<u>36.0%</u>	<u>34.8%</u>

Note 11 Income Taxes (Continued)

Deferred tax assets and liabilities consist of the following (thousands of dollars):

December 31,	2006	2005
Deferred tax assets:		
Deferred income taxes for future amortization of ITC	\$ 6,427	\$ 6,964
Employee benefits	36,542	50,468
Alternative minimum tax	36,820	28,903
Net operating losses & credits	—	37,976
Other	4,549	10,510
Valuation allowance	—	—
	<u>84,338</u>	<u>134,821</u>
Deferred tax liabilities:		
Property-related items, including accelerated depreciation	330,308	337,234
Regulatory balancing accounts	46,207	68,395
Property-related items previously flowed through	8,272	9,411
Unamortized ITC	10,330	11,198
Debt-related costs	5,681	6,292
Other	7,504	5,196
	<u>408,302</u>	<u>437,726</u>
Net deferred tax liabilities	<u>\$323,964</u>	<u>\$302,905</u>
Current	\$ 15,471	\$ 68,166
Noncurrent	<u>308,493</u>	<u>234,739</u>
Net deferred tax liabilities	<u>\$323,964</u>	<u>\$302,905</u>

Company operating segments are determined based on the nature of their activities. The natural gas operations segment is engaged in the business of purchasing, transporting, and distributing natural gas. Revenues are generated from the sale and transportation of natural gas. The construction services segment is engaged in the business of providing utility companies with trenching and installation, replacement, and maintenance services for energy distribution systems.

The accounting policies of the reported segments are the same as those described within **Note 1—Summary of Significant**

**Accounting Policies.** NPL accounts for the services provided to Southwest at contractual (market) prices. At December 31, 2006 and 2005, accounts receivable for these services totaled \$9.2 million and \$8.2 million, respectively, which were not eliminated during consolidation.

The financial information pertaining to the natural gas operations and construction services segments for each of the three years in the period ended December 31, 2006 is as follows (thousands of dollars):

2006	Gas Operations	Construction Services	Adjustments (a)	Total
Revenues from unaffiliated customers	\$1,727,394	\$216,753		\$1,944,147
Intersegment sales	—	80,611		80,611
Total	\$1,727,394	\$297,364		\$2,024,758
Interest expense	\$ 93,291	\$ 1,686		\$ 94,977
Depreciation and amortization	\$ 146,654	\$ 22,310		\$ 168,964
Income tax expense	\$ 36,240	\$ 8,257		\$ 44,497
Segment income	\$ 71,473	\$ 12,387		\$ 83,860
Segment assets	\$3,352,074	\$136,654	\$(3,763)	\$3,484,965
Capital expenditures	\$ 305,914	\$ 39,411		\$ 345,325
2005	Gas Operations	Construction Services	Adjustments (a)	Total
Revenues from unaffiliated customers	\$1,455,257	\$187,249		\$1,642,506
Intersegment sales	—	71,777		71,777
Total	\$1,455,257	\$259,026		\$1,714,283
Interest expense	\$ 89,318	\$ 1,009		\$ 90,327
Depreciation and amortization	\$ 137,981	\$ 18,272		\$ 156,253
Income tax expense	\$ 17,767	\$ 6,845		\$ 24,612
Segment income	\$ 33,670	\$ 10,153		\$ 43,823
Segment assets	\$3,103,804	\$128,181	\$(3,559)	\$3,228,426
Capital expenditures	\$ 258,547	\$ 35,822		\$ 294,369
2004	Gas Operations	Construction Services	Adjustments (a)	Total
Revenues from unaffiliated customers	\$1,262,052	\$153,392		\$1,415,444
Intersegment sales	—	61,616		61,616
Total	\$1,262,052	\$215,008		\$1,477,060
Interest expense	\$ 85,861	\$ 645		\$ 86,506
Depreciation and amortization	\$ 130,515	\$ 15,503		\$ 146,018
Income tax expense	\$ 24,698	\$ 5,539		\$ 30,237
Segment income	\$ 48,354	\$ 8,421		\$ 56,775
Segment assets	\$2,843,199	\$ 99,120	\$(4,203)	\$2,938,116
Capital expenditures	\$ 274,748	\$ 27,940		\$ 302,688

(a) Construction services segment assets include deferred tax assets of \$3 million and income taxes payable of \$758,000 in 2006, which were netted against gas operations segment deferred tax liabilities and income taxes receivable, net during consolidation and deferred tax assets of \$3.6 million and \$4.2 million in 2005 and 2004, respectively, which were netted against gas operations segment deferred tax liabilities during consolidation.

	Quarter Ended			
	March 31	June 30	September 30	December 31
(Thousands of dollars, except per share amounts)				
<b>2006</b>				
Operating revenues	\$676,941	\$430,902	\$351,800	\$565,115
Operating income (loss)	89,325	25,236	3,197	91,424
Net income (loss)	44,180	3,709	(10,736)	46,707
Basic earnings (loss) per common share*	1.12	0.09	(0.26)	1.12
Diluted earnings (loss) per common share*	1.11	0.09	(0.26)	1.11
<b>2005</b>				
Operating revenues	\$542,880	\$361,130	\$313,278	\$496,995
Operating income (loss)	72,849	14,935	(5,459)	68,323
Net income (loss)	32,829	(2,817)	(16,444)	30,255
Basic earnings (loss) per common share*	0.88	(0.07)	(0.43)	0.77
Diluted earnings (loss) per common share*	0.88	(0.07)	(0.43)	0.76
<b>2004</b>				
Operating revenues	\$473,400	\$278,697	\$264,467	\$460,496
Operating income (loss)	85,802	5,954	(9,017)	87,028
Net income (loss)	41,044	(8,362)	(16,353)	40,446
Basic earnings (loss) per common share*	1.19	(0.24)	(0.46)	1.12
Diluted earnings (loss) per common share*	1.18	(0.24)	(0.46)	1.11

\* The sum of quarterly earnings (loss) per average common share may not equal the annual earnings (loss) per share due to the ongoing change in the weighted-average number of common shares outstanding.

The demand for natural gas is seasonal, and it is the opinion of management that comparisons of earnings for the interim periods do not reliably reflect overall trends and changes in the operations of the Company. Also, the timing of

general rate relief can have a significant impact on earnings for interim periods. See Management's Discussion and Analysis for additional discussion of operating results.

Company management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined by Rule 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934. Under the supervision and with the participation of Company management, including the principal executive officer and principal financial officer, the Company conducted an evaluation of the effectiveness of internal control over financial reporting based on the *"Internal Control – Integrated Framework"* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based upon the Company's

evaluation under such framework, Company management concluded that the internal control over financial reporting was effective as of December 31, 2006. Management's assessment of the effectiveness of internal control over financial reporting as of December 31, 2006 has been audited by PricewaterhouseCoopers, LLP, an independent registered public accounting firm, as stated in their report which is included herein.

February 28, 2007

To the Board of Directors and Stockholders of Southwest Gas Corporation

We have completed integrated audits of Southwest Gas Corporation's consolidated financial statements and of its internal control over financial reporting as of December 31, 2006, in accordance with the standards of the Public Company Accounting Oversight Board (United States). Our opinions, based on our audits, are presented below.

*Consolidated financial statements*

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of income, of cash flows and of stockholders' equity and comprehensive income present fairly, in all material respects, the financial position of Southwest Gas Corporation and its subsidiaries at December 31, 2006 and 2005, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2006 in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit of financial statements includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note 1 and Note 9 to the consolidated financial statements, the Company changed the manner in which it accounts for share-based compensation and defined benefit postretirement plans in 2006.

*Internal control over financial reporting*

Also, in our opinion, management's assessment, included in the accompanying Management's Report on Internal Control over Financial Reporting, that the Company maintained effective internal control over financial reporting as of December 31, 2006 based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), is fairly stated, in all material respects, based on those criteria. Furthermore, in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2006, based on criteria

established in Internal Control—Integrated Framework issued by the COSO. The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express opinions on management's assessment and on the effectiveness of the Company's internal control over financial reporting based on our audit. We conducted our audit of internal control over financial reporting in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. An audit of internal control over financial reporting includes obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we consider necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/ PRICEWATERHOUSECOOPERS LLP

Los Angeles, California  
February 28, 2007

# Shareholder Information

## Stock Listing Information

Southwest Gas Corporation's common stock is listed on the New York Stock Exchange under the ticker symbol "SWX." Quotes may be obtained in daily financial newspapers or some local newspapers where it is listed under "SoWestGas."

## Annual Meeting

The Annual Meeting of Shareholders will be held on May 3, 2007 at 10:00 a.m. at the Palms Casino Resort, 4321 West Flamingo Road, Las Vegas, Nevada.

## Dividend Reinvestment and Stock Purchase Plan

The Southwest Gas Corporation Dividend Reinvestment and Stock Purchase Plan (DRSPP) provides its shareholders, natural gas customers, employees and residents of Arizona, California and Nevada with a simple and convenient method of purchasing the Company's common stock and investing cash dividends in additional shares without payment of any brokerage commission.

## The DRSPP features include:

Initial investments of \$100, up to \$100,000 annually  
Automatic investing  
No commissions on purchases  
Safekeeping for common stock certificates

## For more information contact:

Shareholder Services, Southwest Gas Corporation, P. O. Box 98511, Las Vegas, NV 89193-8511 or call (800) 331-1119.

## Dividends

Dividends on common stock are declared quarterly by the Board of Directors. As a general rule, they are payable on the first day of March, June, September and December.

## Investor Relations

Southwest Gas Corporation is committed to providing relevant and complete investment information to shareholders, individual investors and members of the investment community. Additional copies of the Company's 2006 Annual Report on Form 10-K, without exhibits, as filed with the Securities and Exchange Commission may be obtained upon request free of charge. Additional financial information may be obtained by contacting Kenneth J. Kenny, Investor Relations, Southwest Gas Corporation, P. O. Box 98510, Las Vegas, NV 89193-8510 or by calling (702) 876-7237.

Southwest Gas Corporation information is also available on the Internet at [www.swgas.com](http://www.swgas.com). For non-financial information, please call (702) 876-7011.

## Transfer Agent

Shareholder Services  
Southwest Gas Corporation  
P. O. Box 98511  
Las Vegas, NV 89193-8511

## Registrar

Southwest Gas Corporation  
P. O. Box 98510  
Las Vegas, NV 89193-8510

## Auditors

PricewaterhouseCoopers LLP  
350 S. Grand Avenue  
Los Angeles, CA 90071



# Board of Directors and Officers

## Directors

George C. Biehl  
Las Vegas, Nevada  
Executive Vice President/Chief Financial  
Officer and Corporate Secretary  
Southwest Gas Corporation

Thomas E. Chestnut  
Tucson, Arizona  
Owner, President and  
Chief Executive Officer  
Chestnut Construction Company

Stephen C. Comer  
Las Vegas, Nevada  
Retired Partner  
Deloitte & Touche

Richard M. Gardner  
Scottsdale, Arizona  
Retired Partner  
Deloitte & Touche

LeRoy C. Hanneman, Jr.  
Phoenix, Arizona  
Chairman and Chief Executive Officer  
Element Homes, LLC  
Chairman of the Board of Directors  
Southwest Gas Corporation

James J. Kropid  
Las Vegas, Nevada  
President  
James J. Kropid Investments

Michael O. Maffie  
Las Vegas, Nevada  
Retired Chief Executive Officer  
Southwest Gas Corporation

Anne L. Mariucci  
Phoenix, Arizona  
Private Investor

Michael J. Melarkey  
Reno, Nevada  
Partner  
Avansino, Melarkey, Knobel & Mulligan

Jeffrey W. Shaw  
Las Vegas, Nevada  
Chief Executive Officer  
Southwest Gas Corporation

Carolyn M. Sparks  
Las Vegas, Nevada  
President  
International Insurance Services, Ltd.

Terrence L. Wright  
Las Vegas, Nevada  
Owner/Chairman of the Board  
Nevada Title Company

## Officers

Jeffrey W. Shaw  
Chief Executive Officer

James P. Kane  
President

George C. Biehl  
Executive Vice President/Chief Financial  
Officer and Corporate Secretary

John P. Hester  
Senior Vice President/Regulatory Affairs  
and Energy Resources

Edward A. Janov  
Senior Vice President/Finance

Christina A. Palacios  
Senior Vice President/  
Central Arizona Division

Thomas R. Sheets  
Senior Vice President/Legal Affairs and  
General Counsel

Dudley J. Sondeno  
Senior Vice President/Chief Knowledge  
and Technology Officer

Roy R. Centrella  
Vice President/Controller/Chief  
Accounting Officer

Garold L. Clark  
Vice President/  
Southern Arizona Division

Fred W. Cover  
Vice President/Human Resources

Luis F. Frisby  
Vice President/  
Southern California Division

Kenneth J. Kenny  
Vice President/Treasurer

Roger C. Montgomery  
Vice President/Pricing

William N. Moody  
Vice President/Gas Resources

Dennis Redmond  
Vice President/  
Northern Nevada Division

Anita M. Romero  
Vice President/  
Southern Nevada Division

Robert J. Weaver  
Vice President/Information Services

James F. Wunderlin  
Vice President/Engineering



Southwest Gas Corporation  
5241 Spring Mountain Road  
Las Vegas, Nevada 89150

*END*